Santander
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MACRO COMPASS

Mounting Concerns About the Pandemic and the Budget

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- Once again, mounting fiscal concerns and now combined with an adverse market mood towards EMs have put the BRL among the worst performing currencies for the rolling week ending March 25. A worse appetite for EMs and rising fiscal risk has also led the nominal yield curve to considerably steepen with a particularly large sell-off on the back end.
- While the pandemic shows few signs of abating in Brazil, the vaccination process seems to be advancing, reaching a daily average of ~500k. Infections and deaths are still surging, with 17 states reporting ICU occupancy rates above 90%.
- Federal tax collection posted a real increase of 4.3% YoY in February led by a robust performance in corporate taxes. But we expect some moderation in coming months, especially owing to the impact of the pandemic relapse. Next week, the National Treasury and the BCB will publish the February fiscal results.
- The Brazilian Central Bank (BCB) published the minutes of its March 16-17 COPOM policy meeting, occasion when the authority decided to hike the Selic rate by 75bps to 2.75%. We sense the committee chose to keep a hawkish message, in line with its latest decision and its associated flight plan. More hikes are expected for most of 2021.
- March's IPCA-15 registered a 0.93% MoM change (5.52% YoY), in line with market's median expectation of 0.96% but well below our forecast of 1.03%. Despite the downside surprise (vis-à-vis our estimate) in the headline, core measures were a lowlight and, in our view, March's IPCA-15 reinforce the unfavorable scenario for short-term inflation.
- Tertiary activity indicators point to a strong contraction in March. FGV confidence data for households and retail posted a sharp drop to the (rather weak) levels seen in May-2020. Our proprietary coincident indexes for retail sales and services to families also point in the same direction. For the coming week, IBGE will release February industrial production (April 01). The Ministry of Economy will publish CAGED payrolls for February (March 30) and IBGE releases January PNAD household survey data (March 31).
- We expect a March trade surplus (April 1) of USD3.3 billion (consistent with a surplus of USD49.8 billion on a 12-month basis). The outcome should be impacted by the spurious effects of lagged imports of oil platforms.

Most of the information in this report is up to the end of Thursday, March 25, 2021.

Figure 1. Brazil Macro Agenda for the Week of March 29 – April 02, 2021

Indicators	Source	Reference	Date	Santander Estimate	Prior
Total Outstanding Loans (% YoY)	BCB	Feb-21	Mon, 29-Mar	16.1	15.9
Services Confidence (index)	FGV	Mar-21	Mon, 29-Mar	--	83.2
Formal Job Creation (thousands)	CAGED	Feb-21	Tue, 30-Mar	280	260
IGP-M Inflation (% MoM)	FGV	Mar-21	Tue, 30-Mar	3.20	2.53
IGP-M Inflation (% YoY)	FGV	Mar-21	Tue, 30-Mar	31.4	28.9
Central Gov. Prim. Balance (BRL billion)	STN	Feb-21	Tue, 30-Mar	-26.3	43.2
Consolidated Prim. Balance (BRL billion)	BCB	Feb-21	Wed, 31-Mar	-24.2	58.4
Aggregate Business Confidence (points)	FGV	Mar-21	Wed, 31-Mar	--	91.1
National Unemployment Rate (%)	**IBGE**	**Jan-21**	**Wed, 31-Mar**	**14.6**	**13.9**
Industrial Production (% MoM)	**IBGE**	**Feb-21**	**Thu, 01-Apr**	**0.1**	**0.4**
Industrial Production (% YoY)	**IBGE**	**Feb-21**	**Thu, 01-Apr**	**1.3**	**2.0**
Industrial PMI	Markit	Mar-21	Thu, 01-Apr	--	58.4
Trade Balance (USD billion)	SECINT	Mar-21	Thu, 01-Apr	3.3	1.2
Vehicle Sales (thousands)	Fenabrave	Mar-21	Thu, 01-Apr	--	168

Source: Santander Brazil.

For details on Santander's economic forecasts for Brazil, please refer to our last scenario review[1]. For our key views and hypotheses for 2021, please refer to our macro propositions[2].

[1] **Santander Brazil - Macroeconomic Scenario: *"The Persistence of (Fiscal) Risks"* –** February 11, 2021- Available on: http://bit.ly/Sant-ScenRev-fev21
[2] **Santander Brazil** - **"Macro Propositions: Groundhog Year?"** – February 03, 2021- Available on: http://bit.ly/Sant-macro-prop-2021

LOCAL MARKETS—FX

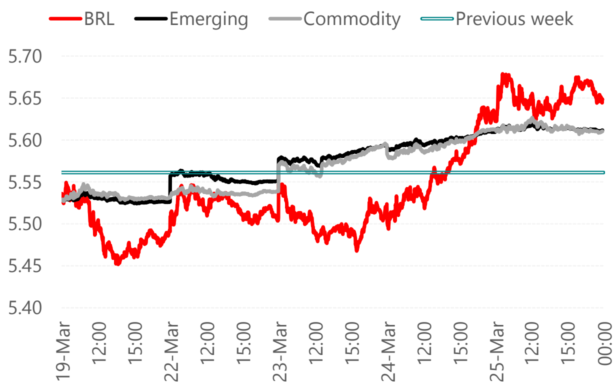
The BRL was one of the worst performers during the March 25 session ending at USD/BRL5.65 after having outperformed the average of emerging and commodity currencies the prior few days (1.6 weaker than on March 18). The news cycle for the emerging market has not been positive recently. For example, the dismissal of the Turkish Central Bank governor on March 19 shook market participants. On the other hand, the fast progress in the immunization program in the US and the partial reversal of the recent steepening of the yield curve brought some respite to risky currencies.

However, with the resurgent pandemic, the temperature on the political front is on the rise. For the short term, this backdrop does not bode well for the progress of structural measures, with pressure increasing for higher government spending. We believe that was the reason behind the poor performance of the BRL on March 25.

LOCAL MARKETS—Rates

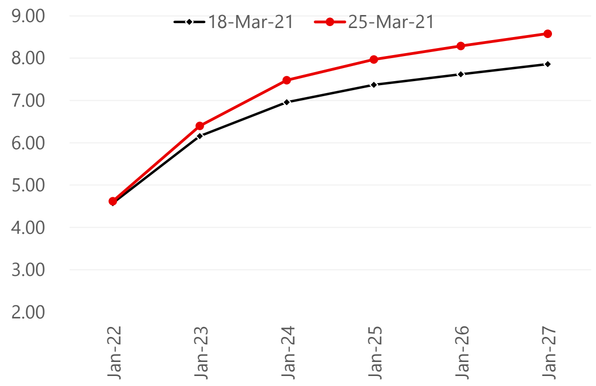
The nominal yield curve steepened considerably. Since our last report (March 18), the front end of the curve (Jan-22 DI future) rose 4 bps to 4.62%, while the back end (Jan-27 DI future) rose 72 bps to 8.58%. Hence, the steepness in this segment increased from 329 bps to 396 bps (+68 bps) since Thursday of last week (March 14). At the front end, the market priced in a tad higher probability of a more *hawkish* move by the BCB during next interest rate decision. Indeed, the implied hike on the curve already points to around 100bps in the next Copom meeting, while the BCB itself signaled a 75bps hike in its last communications. At the long end, and as the pandemic worsens, discussions around further fiscal stimulus remain in place, keeping market risk high.

Figure 2.A. – USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note1: As of the close Thursday, March 25, 2021.
Note2: For other currencies, we use USDBRL values as a base-index

Figure 2.B. – Brazilian Domestic Yield Curve (% p.a.)



Sources: Bloomberg, Santander.
Note: As of the close Thursday, March 25, 2021.

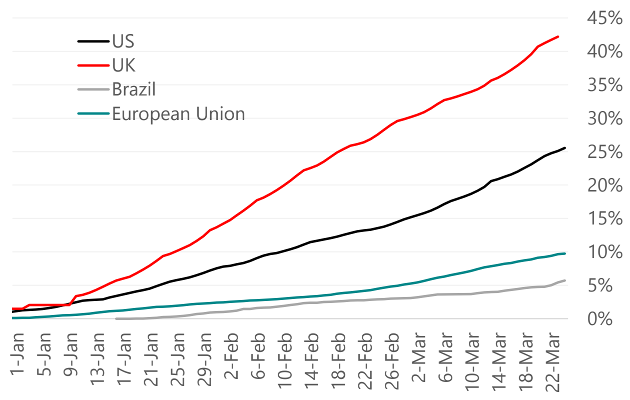
COVID-19 MONITORING

In the U.S., new cases and hospitalizations are flat, while deaths are still falling. The vaccination pace has been steady at 2.5 million/day (7-day moving average) for a few weeks, with nearly 25% of the population having received at least one dose. This figure stands at 41% in the U.K. and at only 9% in the European Union. Amid a third wave of infections, Germany extended its current restriction until April 18, while France is entering a new one month lockdown.

Amid a pandemic that shows few signs of slowing down, vaccinations have been rising in Brazil. The daily new case curve has yet to peak, with deaths numbering 3,251 on Tuesday (March 23, 2021). The ICU occupancy rate is above 90% in at least 17 states. In an attempt to curb the virus transmission, some key regions have brought forward holidays (such as São Paulo municipality and Rio de Janeiro state).

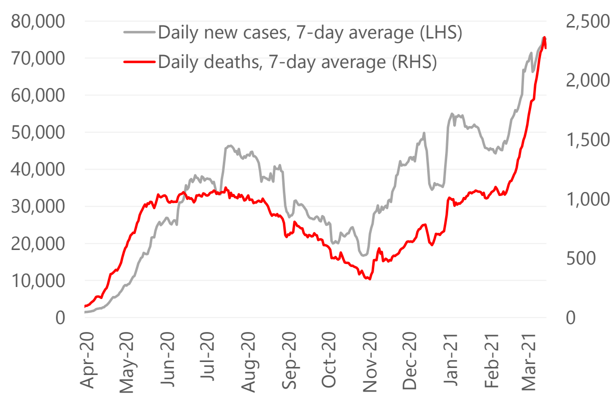
Butantan delivered 5.2 million doses to the Ministry of Health. Another 8.4 million from the institute is expected next week. As of Thursday (March 25, 2021), 17.8 million doses (out of 34 million available) had been administered in the country, with the pace of vaccination at 455k/day (7-day moving average). Data from Brazil's Ministry of Health reported an average of 75k daily new cases (7-day moving average) as of Wednesday (March 24, 2021), up 7% from last week, while daily deaths (7-day moving average) stood at 2,272, up 12.6% in the same comparison.

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



Sources: Our World in Data, Santander.

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



Sources: Brazil Ministry of Health, Santander.

FISCAL POLICY AND POLITICS

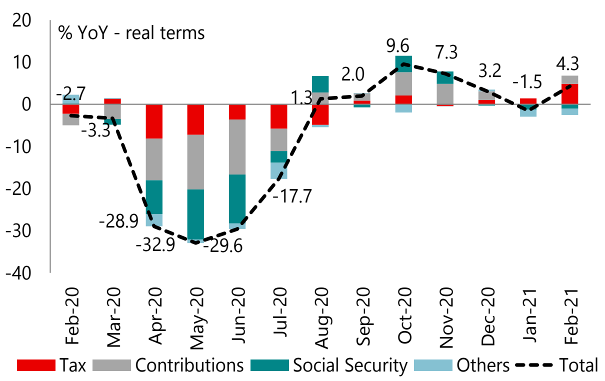
On March 22, the Brazilian Internal Revenue Service (IRS) published the federal tax collection data for February 2021. The monthly result was BRL127.1 billion (or +4.3% real YoY), higher than our forecast (BRL121.5 billion) and the market median (BRL125.5 billion). The positive result reflects robust tax collection by the companies, whose results were possibly affected by a recovery in profit margins following solid economic growth in 4Q20. Moreover, we believe inflation is accelerating, evidenced by higher readjustments of prices due to soaring wholesale costs, a dynamic that should continue to influence tax collection over the next months. February also registered relevant atypical revenues in corporate tax collection (IRPJ /CSLL taxes), totaling BRL5 billion. Additionally, tax compensations continued to increase, with a result of BRL6.1 billion compared to February last year.

Even with the resumption of the Emergency Aid in 2021, which in our view is not expected to generate a significant stimulus to economic activity in 2021, we expect some moderation in tax collection in the coming months. This may occur due to the impact of the deterioration of COVID-19 crisis, which may translate into some softening in real economic activity and tax proceeds. On March 24, the Brazilian IRS announced that, for the period between April and June, the taxes of small business under Simples (a special tax regime) will be deferred. This could add to in deferred tax proceeds ~BRL28 billion. Despite that, considering the inflation effect on business revenues, we are reviewing our revenue forecast which is currently close to +5.0% YoY real growth for 2021 (+1p.p. increase from the last forecast).

On March 24, the National Treasury released the Monthly Debt Report for February 2021. The Federal Public Debt (FPD) issuance reached BRL177.9 billion (second largest in the historical series). The total outstanding debt registered a +2.8% MoM nominal increase, reaching BRL5.2 trillion in February. Moreover, the share of non-residents in the public debt increased from 9.27% to 9.43% in February, with a positive flow of +BRL20.1 billion. Considering the debt management, the debt maturing until April 2021 totaled BRL490.1 billion (or 40.5% of the expected level for 2021). In contrast, the Treasury's liquidity cushion registered a 15.8% nominal increase, shifting from BRL805.7 billion in January to BRL933.2 billion in February, which is enough to cover up to seven months of debt maturities. In our view, the rise in the Selic rate may increase the average cost of new debt issuances in the next few months. Yet, the cost should still be below the average interest rate of the domestic federal debt stock (which was held steady at a record low of 7.2% in February). In our view, even from a debt management standpoint, it is key to approve structural reforms, as it would facilitate an extension of debt maturities and the maintenance of interest rate at low levels.

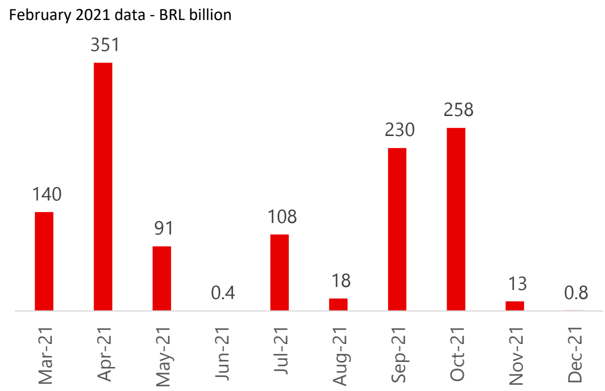
On March 30, the National Treasury is expected to publish the central government primary deficit of February 2021. We expect a deficit of 26.3 billion in the month, considering the increase in revenues and the anticipation of the wage bonus (*Abono Salarial*) to February. On March 31, the BCB will publish the consolidated public sector fiscal balance, which encompasses the federal government, regional governments and state-owned companies. We anticipate a monthly primary deficit of BRL24.2 billion for February 2021.

Figure 4.A. – Federal Tax Collection



Sources: Brazilian Internal Revenue Service, Santander.

Figure 4.B. – Federal Public Debt – Maturity Schedule



Sources: National Treasury, Santander.

MONETARY POLICY

The Brazilian Central Bank (BCB) published the minutes of its March 16-17 COPOM policy meeting, when the authority decided to hike the Selic rate by 75bps to 2.75%. We sense the committee chose to keep a hawkish message, in line with its latest decision and its associated flight plan.

While the authority continues to refer to a "partial normalization" – probably meaning a will to end the hiking process with interest rate below the "neutral" nominal level of 6% – the COPOM believes that the asymmetry in the balance of risks justified faster moves in the policy rate than implied by the inflation simulation in the baseline scenario.

The committee presents sanguine views of the economy, in our view, seeing strong activity recovery in recent months, a faster than expected reduction in job-market slacks, and a solid economic rebound when the effects of the vaccination process start to show (2H21). On inflation, despite the assessment that mounting cost pressures are temporary, the BCB sees the influence of positive demand shocks. Several members of the COPOM saw risks of second-round effects from the higher inflation of late (via inflation expectations for 2022, the key policy horizon).

All in all, we believe the COPOM minutes gave credence to our recently revised Selic rate estimates. We project YE2021 Selic rate at 5.50%, with an additional hike of 75 bps in May and four subsequent moves of 50 bps afterwards. We continue to anticipate a two-stage normalization process, with a pause in 4Q21, before reaching a higher neutral level in 1Q23. See links below[3]

The BCB also published the 1Q21 inflation report, which shed more light on the BCB's inflation forecasts and policy discussions. Having already published its inflation simulations for the relevant policy horizons in the COPOM statement and minutes, a point of note is that the authority now forecasts 2021 GDP at +3.6% (previously +3.8%), with the downward effects of the pandemic partly offset by a better carry over from 2020 and positive data early in 1Q21. According to the BCB, the economy is about 3.2% below its potential in 1Q21 and the output gap is still expected to close in 2022, as the central bank anticipates a strong recovery in the 2H21 on the back of progress in Covid-19 vaccines.

As usual, the inflation report brought interesting policy-related studies (boxes). In one of those, the BCB estimates that imported and food inflation accounted for nearly half of the 4.5% IPCA print seen in 2020. A below-neutral Selic rate accounted for about 1.0 p.p., with inflation expectations (-0.5 p.p.) and the output gap (-2.6 p.p.) exerting key downward contributions for inflation last year. In another study, the BCB focused on the pass through of higher industrial costs to prices: based on the findings of a usually fast transmissions of cost push pressures in the industry and higher than expected price readjustments last year, the BCB concluded that cost pressures tend to ease ahead, barring another spike in commodity or input prices in BRL.

Another box focused on inflation showed BCB inflation forecasts for alternative scenarios, in which the authority tests the impact of a spike in fiscal risks (inflationary) and an extension of the pandemic effects (deflationary). For a combined scenario, assuming 15% of the intensity of the fiscal shock and 50% of the intensity of the pandemic shock, the BCB estimated IPCA about 0.1 p.p. below the baseline estimates for 2021 (given the impact of the weak activity) and 0.2 p.p. above the baseline for 2022 (following the broadening impact of the worse fiscal outlook).

In another study, BCB addressed the increased FX volatility in Brazil, concluding that the interest-rate differential (and the Selic rate) did not show quantitative relevance or explanatory power. Other variables have been found to explain the higher FX volatility, such as global conditions, local risk-premium and trading of mini-contracts in USD futures.

[3] **Santander Brazil Monetary Policy - *"Keeping the Hawkish Tone"* –** March 23, 2021 - Available on: https://bit.ly/Sant-COPOM-230321

ECONOMIC ACTIVITY

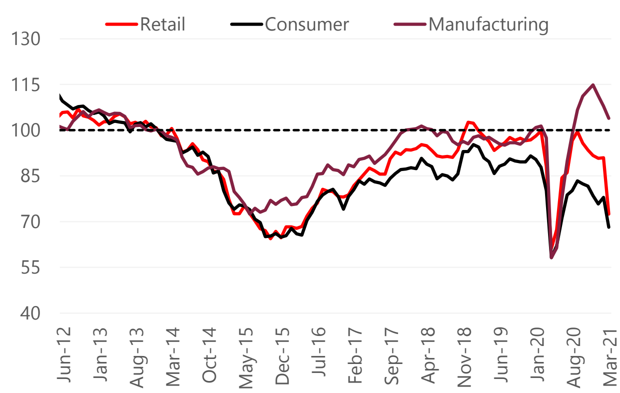
Tertiary sector indicators point to a strong drop in March. FGV released the first batches of economic confidence data, with consumer and retail indexes showing sharp drops (-12.6% and -20.3%, respectively). These figures took both indexes to the lowest readings since May 2020. Our proprietary coincident indexes for retail sales (IGet) and services to families (IGet-Services) also pointed in this direction. Based on our indicators, our tracking of broad retail sales and services to families are -14.0% MoM-sa (+0.8% YoY) and -22.8% MoM-sa (-22.1% YoY), respectively. See links below[4] [5].

Other main sectors of the economy will suffer as well in March. In our view, industry will likely suffer from the impact of a widespread shortage of inputs in manufacturing (also a worldwide issue), compromising supply capacity of domestic industry. Indeed, some factories have announced stoppages in production and granted mandatory vacation to its employees. We also expect services firms to suffer, given the sharp decrease in mobility recorded this month, as social distance measures have tightened to fight the pandemic.

We expect an economic contraction in 1H21. The adverse economic activity outcome expected in March will lead to a quite negative carryover into the coming quarter, requiring strong (and unlikely) sequential growth in subsequent months to mitigate it. In addition, the mobility restrictions extension to April will likely slow the start of the economic resumption, reinforcing the likelihood of sequential decline of economic activity in 2Q21. All in all, lingering impacts of the pandemic should slow the speed of the recovery and will contribute to a likely aggregated contraction taking Q1 and Q2 altogether.

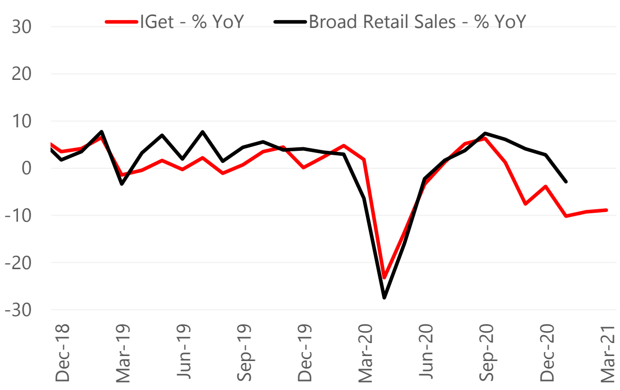
For the coming week, the Ministry of Economy will publish CAGED net formal job creation for February on Tuesday (March 30), for which we expect a +280k headline. Still on the labor market, IBGE will release the January PNAD household survey on Wednesday (March 31). We expect the national unemployment rate to reach 14.6%. IBGE will also release the industrial production for February (April 01), and we expect a sequential monthly increase of 0.1% (1.3% YoY).

Figure 5.A. – FGV Confidence (sa, points)



Sources: FGV, Santander.

Figure 5.B. – Broad Retail Salex x IGet (nsa, % YoY)



Sources: IBGE, Santander.

[4] **Santander Brazil Economic Activity - *"IGet Março (Prévia)"* –** March 23, 2021 - Available (in Portuguese) on: http://bit.ly/Sant-iget-prevmar
[5] **Santander Brazil Economic Activity - *"IGet Serviços Março (Prévia)"* –** March 19, 2021 - Available (in Portuguese) on: http://bit.ly/Sant-Iget-serv-prevmar

INFLATION

March's IPCA-15 registered a 0.93% MoM change (5.52% YoY), basically in line with market's median expectation of 0.96% but well below our forecast of 1.03%.

Downside surprises were spread among free prices groups. Services were a highlight, contributing -5 bps of deviation to the headline forecast error. Food-at-home was another group, contributing -5 bps to the error. Industrial goods contributed a very slight -2 bps to the forecast error, but posted a very high change of 1.07% MoM. Finally, administered prices surprised in the other direction adding +2 bps to the forecast error.

Core measures were a lowlight, as expected. Indeed, the average of core measures saw its trend (3mma-saar) rise from 5.1% to 5.6%, a considerably high level. Particularly, industrial goods continue to add upward pressure, as they accelerated from 8.6% to 9.2% in 3mma-saar levels. Moreover, the core of services accelerated in 3mma-saar terms from 3.3% to 4.8%. Finally, diffusion stood almost steady at 61.7%, a level higher than in pre-pandemic times.

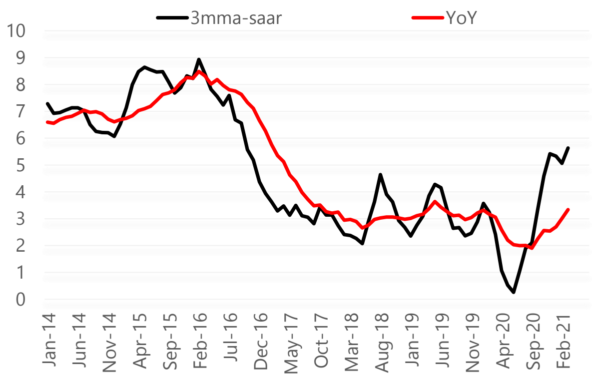
In our view, despite the downside surprise, March's IPCA-15 reinforce the unfavorable scenario for short-term inflation, indicating that shocks seem to be affecting core measures —a sign, in our view, that the risk of secondary effects on inflation is rising. Another sign in that direction is the diffusion index in high levels are also a sing on that direction. See links below[6].

Figure 6.A – IPCA Monthly (%)

	MoM			YoY	
	Mar-21	Santander	Cont.	Feb-21	Mar-21
IPCA-15	0.93	1.03	-0.10	4.6	5.5
Administered	2.66	2.59	0.02	2.3	5.3
Free	0.34	0.50	-0.12	5.4	5.6
Food-at-home	-0.03	0.30	-0.05	19.1	18.5
Industrial goods	1.00	1.07	-0.02	4.1	4.7
Services	0.08	0.22	-0.05	1.3	1.6
EX3 Core	0.46	0.42	0.04	3.0	3.2
Average of cores	0.46	-	-	3.0	3.3

Sources: IBGE, Santander.

Figure 6.B. – Core Inflation (IPCA EX3, %)



Sources: IBGE, Brazilian Central Bank, Santander.

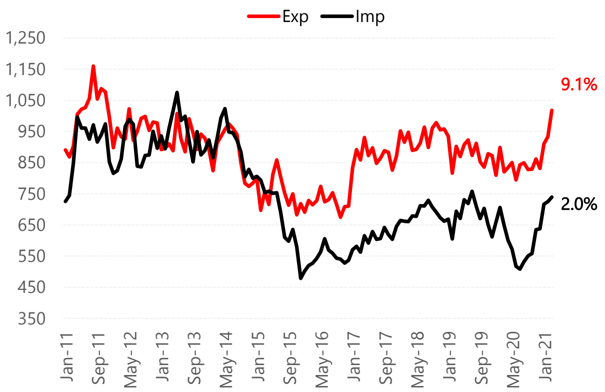
[6] **Santander Brazil Economic Inflation - *"IPCA-15 March: Core Measures Remain Under Pressure"* –** March 25, 2021 - Available on: https://bit.ly/Sant-IPCA15-250321

TRADE BALANCE

Although the deadline for imports of oil platforms to benefit from tax changes expired last December, we are still witnessing the arrival of some deals, which we expect to hit the March 2021 trade balance, as was the case in January and February. Were it not for this technical issue, our forecast for the trade surplus this month would be USD6.9 billion instead of the USD3.3 billion we expect to be announced next Thursday, April 1. Therefore, stripping out deals related to these oil-rigs, the USD49.8 billion surplus on a 12M-to-date basis would indeed be USD64.6 billion. Unfortunately, there is still uncertainty about how long these accounting transactions will continue to affect the trade statistics.

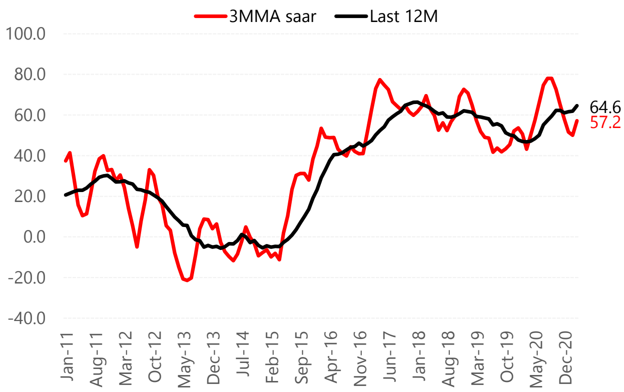
Therefore, taking into account the underlying dynamics of the Brazilian foreign trade, we expect about a 9.1% MoM sa increase in the exports daily average as compared to an expansion of 2.0% in the imports daily average in the same terms. That is an indication of the outperformance we expect exports to present as compared with imports this year, which should lead the country to register a more robust trade surplus in 2021 than the one registered in 2020. We project it to reach as high as USD78.4 billion from USD50.9 billion seen in the previous year. In sum, external sector data should continue to provide a good contribution for the country's fundamentals.

Figure 7.A – Trade Balance Ex Oil Platforms - (US$ million/working day, sa)



Sources: SECINT, Santander.

Figure 7.B.– Trade Balance Ex Oil Platforms - (US$ billion)



Sources: SECINT, Santander.

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