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Brazil Macro Compass

Return of 2020 GDP Upside Risk?

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- **With the lack of major fiscal news recently, the BRL has benefited from the global weakening of the USD and is once again about to end the week near USDBRL5.30, off the recent peaks in the FX rate.**
- **The nominal yield curve bear-steepened this week, with the Jan-27 vs. Jan-22 gap moving back north of 400 bps. A similar movement in U.S. Treasuries, solid activity figures for July, and large bond auctions by the National Treasury seem to have influenced this movement, in our view.**
- **Retail activity has confirmed expectations of another gain in July. Headline broad retail sales rose 7.2% MoM s.a. (1.6% YoY) in July, considerably better than the market consensus of 5.7% MoM s.a. (1.8% YoY), but in line with our call (+7.9% MoM s.a.). The headline index has returned nearly to pre-crisis levels, at only 2% short of the reading in February. Meanwhile, the core index is now 5.3% above the reading for February and has reached the level last seen in December 2014. Looking ahead, we believe the evidence suggests that the shopping spree continued in August, as our proprietary coincident index for retail sales (IGet) posted a gain of 28.2% MoM s.a.**
- **The services sector, the laggard in this recovery, has also confirmed expectations of another gain early in 3Q. The headline index posted a year-over-year decline of 11.9%, shy of the consensus (-10.1% YoY), but the sequential gain was 2.6% MoM s.a., which implies a recovery of nearly 30% of the loss caused by the pandemic. The services headline is still 12.5% below the reading for February.**
- **Given the data available as of this writing, we have updated our projection for IBC-Br (BCB's monthly activity index) to +3.4% MoM s.a. (-5.4% YoY), the third gain in a row since April's sharp drop. This result implies that the index for July will come in 6.6% below the pre-crisis reading. Our GDP tracking for 3Q20 stands at +7.9 QoQ s.a. (-4.3% YoY), meaning (once again) significant upside risk to our full year 2020 GDP forecast, which has stood at -6.4% since early May.**
- **August's IPCA registered a 0.24% MoM change (2.44% YoY). The result was in line with the market's expectation, but slightly below our estimate of 0.28% MoM. Our tracking of 2020's IPCA inflation has been hovering around 1.7-1.9% (above our official forecast of 1.5%) for a while now, and the upward pressures have resumed; now the tracking is at 2.0%, with upside risks (mainly from food-at-home). Despite that short-term upward pressure, we continue to see a muted pace of increases in core prices. Well-anchored inflation expectations also are likely to play a key role, in our view. As a result, for 2021 we continue to see IPCA inflation at 2.7%.**
- **On Wednesday (September 16), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. Sharing the (virtually unanimous) expectations of analysts, we see the Copom keeping the Selic policy rate on hold at 2.00%, a historical low. Even if there is little news in the Copom decision, the statement will be noteworthy. We believe the committee will maintain the forward guidance introduced at the previous meeting (basically meaning no hikes for the foreseeable future) and imply a neutral tone overall.**
- **On the fiscal side, it is important to monitor the possible release of the report on the Federative Pact (constitutional reform) next week, which is expected to accommodate the creation of the new welfare**

program (to be known as *Renda Brasil*) without threatening the constitutional spending cap. The debate over the proposal will be key in shaping the fiscal outlook for the coming years, in our view. On Wednesday, Congress may also vote on whether to overturn several presidential vetoes, with a focus on the extension of the payroll tax breaks for 2021, which could mean less revenue and reduce a bit further the margin to comply with the spending cap for 2021.

Local markets—FX: This week, we saw no major news related to discussions of the budget bill for 2021. However, specifically in this case, "no news is good news", in our view, as it means the commitment to fiscal discipline remains in place (at least for the moment). In addition, the discussions between the lawmakers and the federal administration continue to indicate that both parties are aware of the economic and financial risks of seeking further budgetary expansion via loopholes in the constitutional spending cap. Further, even the debate about the inception of a new welfare program—christened *Renda Brasil*—is apparently being limited by the narrow margin to impose the spending cap in the coming years. With fiscal concerns (at least temporarily) aside and a global weakening of the USD in the last few days, the BRL is about to end the week near USDBRL5.30 for a second week, off the recent peaks in the FX rate. This reinforces our baseline hypothesis that credible signs of commitment to fiscal discipline are likely to lead the BRL to stronger levels later this year. Nonetheless, we believe that the fiscal debate has yet to heat up, so the currency should remain subject to considerable volatility ahead.

Local markets—rates: Based on prices from Friday morning (time of writing), the nominal yield curve (once again) bear-steepened this week. On the front end, the Jan-22 DI future was about to close the week at 2.83% (+9 bps from last Friday). On the back end, the Jan-27 DI future was trading at 6.91% (+27 bps from last Friday), pushing the steepness in this segment (i.e., 2027s vs. 2022s) to nearly 408 bps, compared to 390 bps in the previous week and ~150 bps early this year.

A similar movement was seen in U.S. Treasury yields, probably indicating a global influence on that pattern. In our view, however, local factors also played a key role in the yield curve's bearishness this week. On the front end, there is consensus that no rate change is in the making for the Copom meeting on Wednesday. Short-term upward pressure in inflation this week, as well as above-expectations gains in retail activity may have played a part. On the back end, local bond auctions carried out by the National Treasury pressured the belly and all the way up to the back end of the curve.

We continue to see hefty premia in the local yield curve, especially on the back end. A major reduction in this "fat" hinges on a clear government-parliament decision to keep budget policies within the limits imposed by the constitutional spending cap. All in all, we still expect fiscal uncertainty to linger and volatility to stick around, at least for a while.

Economic activity: Retail activity has confirmed our expectation of another solid gain for July. Headline broad retail sales rose 7.2% MoM s.a. (1.6% YoY), better than market consensus of 5.7% MoM s.a. and close to our forecast of 7.9% MoM s.a. The core retail index (ex-auto and construction) posted a gain of 5.2% MoM s.a. (5.5% YoY), way above the consensus of 1.1% MoM s.a. and not far from our estimate of 4.4% MoM s.a. Following the core retail movement in the previous month, the broad index has virtually recovered all of the loss registered between March and April (93%), and now is only 2% below the reading of February (pre-crisis level). The core index is now 5.3% above the reading for February and has reached the level last seen in December 2014.

Looking ahead, we believe evidence suggests that the shopping spree continued in August. Our proprietary coincident index for retail sales (IGet) posted a gain of 28.2% MoM s.a., reinforcing the indications that April was the worst month for activity this year, with a gradual sequential recovery afterward. The magnitude of the gain itself must be taken with a grain of salt, since important segments that compose the index may be capturing some upward noise (e.g., the Supermarket segment may be disproportionately reflecting the effect on the retail sales index of the reopening of food services in some key regions). Despite that, we believe that the easing of social isolation measures and the maintenance of emergency aid (corona vouchers) will continue to boost consumption of goods throughout 3Q20.

In July, the services sector, the laggard in this recovery process, posted another gain. The year-over-year headline index was negative (-11.9% YoY) and worse than consensus (-10.1% YoY). On a sequential basis, however, the gain was 2.6% MoM s.a., which implies a recovery of 30.2% of the ground lost since the crisis began. Nevertheless, the services headline is still 12.5% below the reading for February. Among segments, July's positive result was primarily driven by Information (2.2% MoM s.a.), Transport (2.3% MoM s.a.), and Professional (2.0% MoM s.a.), while the Families segment posted a decline (-3.9% MoM s.a.). Services to Families and Transport, which registered sharp drops during the crisis, are still 56.6% and 14.4% below their readings for February. Other Services, which includes Health Insurance, Insurance Brokers, and Pensions, posted another gain of 3.0% MoM s.a., a reading that is only 2.6% below the pre-crisis level. Regarding the diffusion index, 10 of the 11 subsectors posted monthly gains, and the negative reading for Families was due to a substantial decline in Accommodation and Food (-5.0% MoM s.a.).

Inflation: August's IPCA registered a 0.24% MoM change (2.44% YoY). The result was in line with the market's expectation, but slightly below our estimate of 0.28% MoM.

The downside surprises were concentrated in free prices. Particularly, the main surprise was in industrial goods, which rose 0.22% MoM vs. our expectation of 0.47% (contributing -6 bps of difference to our headline forecast error)—apparently the (already small) pass-through is getting weaker. Services were fairly in line with our expectation, falling 0.47% (we estimated -0.45%). The upside surprise in free prices came in food-at-home, which rose 1.15% MoM, while we expected 1.04% (+2 bps of error to the headline forecast)—the pass-through from wholesale to consumers was higher than we expected for proteins in August. Finally, administered prices were also a small upside surprise (+1 bps)—gas stations were able to make a lagged pass-through of the rise in gasoline refineries' prices.

The new average of core measures (EX0, E3, DP, MS, and P55) registered a 0.10% MoM change, with the annualized (and seasonally adjusted) three-month moving average reaching a muted 1.5%, while the target for 2020 is 4.0%. In particular, the trend for the IPCA EX3 core gauge—a measure highly correlated with the output gap—is hovering around 1.0% MM3saar. Additionally, the diffusion index stood at 58.0% on a seasonally adjusted basis, still close to the lowest historical levels.

Our tracking of 2020 IPCA inflation has been hovering around 1.7-1.9% (above our official forecast of 1.5%) for a while now, and upward pressures have resumed; now the tracking is at 2.0%, with upside risks (mainly from food-at-home). Despite that short-term upward pressure, we continue to see a muted pace of increases in core prices, as we expect economic slack to remain high for a considerable period, despite the cushioning of demand generated by government stimulus and the reopening of a number of regional economies. Well-anchored inflation expectations also are likely to play a key role, in our view. As a result, for 2021 we continue to see IPCA inflation at 2.7%.

Monetary policy: On Wednesday (September 16), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. Sharing the (virtually unanimous) expectations of analysts, we see the Copom keeping the Selic policy rate on hold at 2.00%, a historical low. While that would be the first time the Copom has kept the rate unchanged since June 2019, we believe the conditions around the meeting mean that it is likely to be a "dead" one.

Fiscal (and, to a lesser degree, regulatory) concerns continue to feed discussions about an effective lower bound for interest rates. It is widely accepted among economists that the latter fluctuates over time and that the current level of the Selic rate may now be close to that lower bound. If this is true, we believe that new interest rate stimuli at this juncture could likely prompt counterproductive consequences for the economy (i.e., do more harm than good).

Given the potentially adverse effects of a fiscal deterioration on the level of neutral interest rates and the anchoring of inflation expectations, we believe this is an appropriate time to monitor where fiscal policy is heading (amid ongoing discussions on the 2021 budget and government programs). The time is also ripe to watch the behavior of the broader economy in response to the strong (fiscal and monetary) stimuli implemented to fight the economic effects of the COVID-19 pandemic.

Even if there is little news when it comes to the Copom decision, the statement will be noteworthy. Here, we believe that Copom will keep the forward guidance introduced at the previous meeting, whereby the authority signals the possibility of small rate cuts and, maybe more emphatically, no rate hikes for the foreseeable future if inflation expectations continue to run below the target (for the relevant policy horizon), and assuming that the fiscal regime remains unchanged and long-term expectations remain well-anchored.

It is possible, in our view, that the Copom will formally hint at a limited likelihood that new rate cuts will materialize in the short term. We think this is largely due to a recent increase in market tensions regarding the (perceptibly) rising execution risks for the fiscal adjustment process after the pandemic. Even if stemming from volatile items (e.g., food, energy), upward price pressures may also help induce a bit of caution on the part of the authority. The same goes for an apparently firmer recovery in economic activity—especially that signaled by preliminary data for 3Q20. That data is confirming the upside risks viewed by the BCB as per its own 2020 GDP forecast of -6.4%, presented in the 2Q inflation report. We believe that better activity probably contributes to reducing, at least for now, the sense of urgency to introduce additional stimulus, given the highly expansionary current stance.

Amid a short-term pickup in IPCA inflation, based on volatile items and limited FX pass-through, we believe that the Copom will continue to rule out the possibility of more persistent and widespread price pressures, given the muted underlying inflation figures and still comfortable inflation fundamentals (anchored inflation expectations, outsized labor slack). Thus, we do not expect a hawkish tone from the BCB in the communiqué.

Fiscal policy: On the fiscal front, it is important to monitor the possibility that Congress will vote next week on whether to overturn several presidential vetoes. We believe a session of Congress may be called for next Wednesday. Focus will be on the presidential veto of the extension of the payroll exemption to 17 labor-intensive sectors in 2021. If Congress overturns the veto, and the payroll tax exemption continues, it would make compliance with the spending cap for 2021 even more difficult—adding up to BRL6.5 billion in new expenses (as the Treasury has to “repay” part of the nearly BRL12 billion in tax breaks to the INSS, or social security institute).

In addition, we believe that next week the Federal Pact rapporteur may unveil his draft on the proposal for a constitutional amendment that is to include the creation of fiscal mechanisms to curb mandatory expenses. The rapporteur, who has been working with the government’s economics team, postponed his draft presentation (previously expected for September 9) to include the creation of a new welfare program (to be known as *Renda Brasil*). These fiscal triggers would reduce expenses and therefore free up space in the budget. The preliminary savings estimate from the government is between BRL25 billion and BRL30 billion in next year's budget, which we believe is probably to accommodate *Renda Brasil* within the boundaries imposed by the spending cap.

Next week: On the activity front, the BCB will release IBC-Br on Monday (September 14). Given the data available up to now, we updated our projection for IBC-Br (BCB’s monthly activity index) to +3.4% MoM s.a. (-5.4% YoY), the third gain in a row since April’s sharp drop. This result would imply a recovery of 56.3% of the decline caused by the pandemic (March and April), with the index expected to stand at 6.6% below the pre-crisis reading (February). Based on these figures, we are tracking GDP growth for 3Q20 at +7.9 QoQ s.a. (-4.3% YoY). These numbers imply considerable upside risk for our full year 2020 GDP forecast, which has stood at -6.4% since early May.

On inflation, the IGP-10 will be released on Wednesday, and we expect the index to continue to be pressured by wholesale prices (both agro and industrial ones); our forecast is 3.95% MoM. However, we expect limited pass-through to the CPI.

MACRO AGENDA

Indicator	Date	Estimate	Prior
IBC-Br Economic Activity Index Jul/20 (% MoM)	Mon, Sep 14	+3.4	+4.9
IBC-Br Economic Activity Index Jul/20 (% YoY)	Mon, Sep 14	-5.4	-7.1
IGP-10 Inflation (% MoM)	Wed, Sep 16	3.93	2.53
Copom Selic rate announcement (% p.a.)	Wed, Sep 16	2.00	2.00
IGP-M Inflation 2nd preview (% MoM)	Fri, Sep 18	-	2.34

Sources: Bloomberg and Santander.

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