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Corporate & Investment Banking

The Fiscal Cost of the Recovery

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- **Although the news cycle regarding the U.S. fiscal package, the U.S. presidential race and the prospects for the Brazilian fiscal policy has not been significantly novel as of late, a burgeoning second wave of COVID-19in Europe has led the USD to strengthen against nearly all currencies, including the BRL.**

- **In fixed income, the week saw a flattening pattern in nominal yields, with upward pressures in the front end (e.g., Jan-22 DI future up 6 bps from last Friday), possibly reflecting the fiscal risks to the Brazil Central Bank's (BCB) forward guidance of stable interest rates for some time. We continue to anticipate hefty premium and volatility for the yield curve for the coming weeks and months, until there is more clarity on the fiscal path.**

- **IBGE's data on the services sector pointed to an increase of 2.9% MoM s.a. (-10.0% YoY), but the headline index is still 9.8% below February's reading, making this the weakest end of the recovery process. In the BCB's monthly activity index for August, we saw a gain of 1.1% MoM s.a. (-3.9% YoY), implying the index is down by 4.2% since February (71% recovery rate). In a preliminary exercise based on August's result carryover, our tracking for 3Q20 GDP stands at 9.8% QoQ s.a. (-2.8% YoY), meaning a (temporarily) sharp recovery from a steep drop in 2Q20.**

- **On the fiscal side, the Fiscal Monitor report, released by International Monetary Fund (IMF) on October 14, reinforced the challenging outlook for fiscal policy in Brazil. Following a budgetary impulse of ~8% of GDP this year (above the EM average, 3-4%), the IMF predicts that Brazilian public gross debt/GDP will exceed 100% of GDP (in its own metric), reaching the second highest level among emerging economies for 2020. What's worse, the IMF believes the debt will not stabilize before 2025 at the earliest.**

- **On Friday, IBGE releases the IPCA-15 inflation for October. We expect a reading of +0.89% MoM (+3.47% YoY). The reading will continue to be pressured by food, but this time industrial goods and services will help to accelerate the MoM reading. Despite those temporary upward pressures in 2020, we continue to anticipate a benign scenario for 2021.**

- **We estimate the current account balance to have registered a USD2.7 billion surplus in September, which should have still been driven by a strong hit on expenditures (imports, tourism outlays, remittance of profit and dividends) rather than by an increase in revenue. We expect that result to drive the annual deficit down to USD20 billion, from nearly USD51 billion at year-end 2019.**

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Local markets—FX: In our opinion, the news cycle regarding most of the key themes for market participants failed to bring significant novelties this week, as the likely timing for the introduction of a new fiscal package in the U.S. continued to be after the presidential race, which by its turn continued to show opinion polls that favor the Democrat candidate, though these do not point to a landslide, according to the FT poll tracker based on data by Real Clear Politics. On the domestic front, discussions regarding the public budget for 2021 and the implementation of a new welfare program have been paused. In sum, it should have been a period of relatively stable behavior for the BRL.

However, we think that a burgeoning second wave of COVID-19 in Europe has dissatisfied market participants, as this second wave may thwart the expected global economic recovery. As a result, we saw market participants fleeing to the USD, which should lead the BRL to weaken this week (as of this writing, the USDBRL was quoted at 5.63 from 5.53 last Friday), despite the USD0.6 billion intervention in the spot market carried by BCB last Tuesday. All in all, we think the move just reinforces the need for progress on the domestic fiscal front so as to insulate the BRL from negative developments abroad.

Local markets—rates: At the time of writing (Friday, around noon, local time), the weekly change in nominal yields pointed to a flattening pattern. In the front end, the Jan-22 DI future was standing at 3.29% (+6 bps from last Friday), possibly reflecting the fiscal risks to the BCB's forward guidance of stable interest rates for some time. In the belly/back end, the Jan-25 DI future was trading at 6.52% (-3 bps from last Friday), with the steepness in this segment poised to end the week at ~323 bps, compared to 332 bps in the previous week and ~130 bps prior to the arrival of the pandemic in Brazil (March).

If the external backdrop did not seem to provide much respite to local yields this week (refer to the previous section for details), local factors continue to play a key role in pressuring local rates higher. This is on the back of lingering perception of greater fiscal risks given the dilemma between a desired expansion of welfare programs and a necessity to maintain the credibility of the fiscal regime. Proposals (by the executive and legislative branches) will be announced to the general public no earlier than November's municipal elections; as such, markets worry about the feasibility of complying with the constitutional spending cap in the coming years.

In this context, markets remain worried not only about the long-term outlook for debt solvency but also about the conditions for government debt management in the short term, given a sizable maturity of federal debt expiring in coming months (for details, refer to our October 7 report, *Borrowing Requirements and Debt Management: The Importance of the Fiscal Adjustment*). This week brought a respite, with the BCB and the National Treasury's (NT) coordinated announcement about a reduced size of repo operations for late October and a commitment to shortening maturity of new issuances.

As per our baseline scenario (of fiscal convergence, with a still credible but elusive spending cap and with a stable Selic rate across 2021), we think that the yield curve has hefty premia in both the front and back end (refer to our October 6 report, *Mind the (Fiscal Risk) Premium*). But this premium will not erode considerably until we see clear signs of a credible fiscal consolidation once the pandemic is over. Thus, we expect volatility to remain high in Brazil's fixed income markets for the coming weeks and months.

Economic activity: In September, our proprietary coincident index of retail sales (IGet) pointed to the first decline after four gains in a row (-0.8% MoM s.a.). The indexes, weighted according to core and broad retail sales methodology, pointed to monthly declines of -0.1% and -1.7%. Temporary measures of income support have played an important role in the consumption dynamic, so that, given adverse cyclical conditions in the labor market, the speed of recovery should tend to moderate more in the coming months.

Data on the services sector released by IBGE on Wednesday has confirmed market expectations of another gain in August. The headline index posted a variation of –10.0% YoY, a slightly better result than the market consensus projection (-10.2% YoY). After seasonal adjustments, the index registered an increase of 2.9% MoM s.a., the third gain in a row after May's bottom and April's sharp drop. This positive result implies that 45.3% of the losses registered during the crisis have already been recovered. In comparison with February's reading, the headline is still 9.8% below the pre-crisis level.

On Thursday, the BCB has published its monthly activity for August, capping the batch of activity indexes releases for that month. The IBC-Br posted a gain of 1.1% MoM s.a. (-3.9 YoY), below the market consensus forecast of 1.7% MoM s.a. (but with July's number revised upward). This result implies that 71.4% of the losses registered between March and April have already been recovered, but the index is still 4.2% below February's reading. This result is consistent with the sequential resumption in activity seen for other key sector-based indicators in August (e.g., industrial production, retail

sales, services sector). In a preliminary exercise based on August's result carryover, our tracking for 3Q20 GDP stands at 9.8% QoQ s.a. (-2.8% YoY), , meaning a (temporarily) sharp recovery from a steep drop in 2Q20.

FGV has released this week the preview of confidence data for October. The positive highlight was Industry confidence, pointing to another monthly growth (5.1%), reaching the highest reading since March 2011. On the other side, Consumer, Retail and Services confidences posted the first declines after fifth gains in a row. Consumer and Retail confidences, which were close to pre-crisis level last month, posted declines of -4.7% and -5.1%, respectively, while Services confidence, the most laggard sector in the recovery and substantially below February's reading, pointed to a fall of -1.6%. Construction remained virtually stable.

Fiscal policy: On the fiscal side, the Fiscal Monitor report, released by International Monetary Fund (IMF) on October 14, reinforced the challenging outlook for the fiscal accounts in Brazil. The IMF predicts that Brazilian public gross debt/GDP will reach 101% in 2020 (+12 p.p from 2019), the second largest among emerging economies (EM). This debt level considers the expenses to mitigate the pandemic effects, the total stimulus of the country will reach 8.3% of GDP this year, higher than the average of EM (3.4% of GDP) and close to advanced economies (9.3% of GDP). Note: the IMF methodology posted a gap of nearly 14 p.p. vis-à-vis official BCB statistics for last year, as the IMF calculations encompass the Treasury bonds directly issued in the name of the BCB (which uses those for purposes of monetary policy implementation) not allocated to repo operations.

The IMF debt forecasts that Brazil will not stabilize before 2025 and considers compliance to the spending cap rule in this scenario. The institution emphasizes the importance of the approval of the economic reforms that were already being discussed by Congress even before the pandemic. In short, the numbers are close to our fiscal scenario and reinforce our belief that the creation of new mandatory expenses should be limited in the spending cap rule in order to guarantee the credibility of the fiscal consolidation process once the pandemic is behind us.

Inflation: On Friday (October 23), IBGE releases the IPCA-15 inflation (preview) for October. We expect a reading of +0.89% MoM (+3.47% YoY). The main source of upward pressure will be, again, food-at-home inflation. We forecast this group will rise 3.37% 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 will also rise considerably. Industrial goods continue to be pressured by the same drivers of food and, on top of these, the sector is also suffering some (located and temporary) supply shortages, so we believe it will rise 0.65% MoM. On services, which has been registering very low prints since the begging of the pandemic, the pressure on this reading will be very located on one item – airline tickets, which should rise 51.0% MoM-- but the rest of the sector should continue to show very low changes; we forecast the group will rise 0.64% MoM. Finally, administered prices should rise 0.11% MoM.

The risk for our 2020 headline IPCA forecast tilts to the upside (mainly, because of food-at-home, but also because of industrial goods). Our official number is 2.3%, but our high-frequency tracking is at 3.0%. For 2021, however, we continue to forecast 2.7% of IPCA inflation. 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 will continue on a benign path.

Balance of payments: Next Friday we will learn the Brazilian external sector data for September 2020. We expect the current account balance to have registered a USD2.7 billion surplus, which will have meant—if our estimate proves right—a USD20.0 billion deficit in 12-month-to-date terms as compared with a USD50.9 billion imbalance in December 2019. We expect the outcome to underpin our perception that the Brazilian balance-of-payments has ended its previous role as a crisis aggravator in the country, rather turning into an automatic stabilizer for these periods. We expect the deficit in 12-month terms to contract further in the coming releases, ending at USD9.3 billion by December 2020, thereby underpinning that transformation.

On top of the current account surplus, we also calculate that direct investments in the country should have registered a USD2.0 billion inflow last month, which would have led—if our calculation proves right—to a USD50.4 billion net inflow in 12-month-to-date terms. That level is far above the current account deficit in the same terms, thus reinforcing the perception that the country is in a comfortable position as far as its external financing sources are concerned. Therefore, we believe one cannot ascribe the current high volatility of the BRL to the fundamentals of the Brazilian balance of payments. The cause for that lies on a different front.

Also next week: FGV will release the final consumer confidence data for October. If confirmed FGV's previews result, Consumer confidence will register the first negative reading after fifth gains in a row. In our view, this decline is due to the gradual reduction of emergency aid value, since the payment was made at the end of September, with relevant effects only in October.

MACRO AGENDA

Indicator	Date	Estimate	Prior
IGP-M Inflation 2nd Preview Oct/20 (% MoM)	Tue, 20-Oct	--	4.57
FGV CPI IPC-S Oct/20	Fri, 23-Oct	--	
FGV Consumer Confidence Oct/20 (points)	Fri, 23-Oct	--	83.4
IBGE Inflation IPCA-15 Oct/20 (% MoM)	Fri, 23-Oct	0.89	0.45
IBGE Inflation IPCA-15 Oct/20 (% YoY)	Fri, 23-Oct	3.47	2.65
Current Account Balance Sep/20 (USD billion)	Fri, 23-Oct	2.7	3.7
Foreign Direct Investment Sep/20 (USD billion)	Fri, 23-Oct	2.0	1.4

Sources: Bloomberg and Santander.

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