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Brazil Macro Compass

The Recovery Continued in August

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- **On the heels of a global risk-off (possibly triggered by fears of a second wave of COVID-19 in Europe and electoral tensions in the US), and amid a lack of progress on macro reforms on the domestic front, the USDBRL pair went back to the 5.50-5.60 range, making the BRL one of the worst performers in the class of emerging currencies.**

- **The local yield curve has bull-steepened this week, reversing part of the bearishness seen lately. Despite the global sell-off, it appears to us that successful bond auctions by the National Treasury (i.e. with a good bid-to-cover ratio) allowed some respite. We continue to anticipate volatility and premia for Brazilian assets until we have greater clarity on the unfolding discussions on the fiscal side.**

- **The BCB (Brazilian Central Bank) published minutes from the September 15-16 Copom meeting, which brought little additional news beyond recent communications. The BCB continues to reaffirm its forward guidance of no hikes ahead, as the committee sees the conditions still in place for the continuation of that forward guidance. Those include an unchanged fiscal regime, inflation estimates below the target for the medium term, and expectations well anchored in the long run. The authority also published the 3Q20 inflation report, which added a few details on the BCB's inflation forecasts and presented some interesting policy discussions that justify the BCB's flight plan, in our view.**

- **September's IPCA-15 registered a 0.45% MoM change (2.65% YoY). The result was a bit above the market's median expectation (0.39%) and our forecast (0.40%). Despite the small upside surprise, we continue to envision a benign scenario for inflation, as the main pressure has been food-at-home (a volatile and non-core-related group). We believe the scenario of high economic slack should prevail and keep inflation with a benign composition (low core measures) and on a benign path for the medium term. Well-anchored inflation expectations should also play a major role in this outlook. Our 2020 IPCA forecast was recently revised upward in June to 2.3% from 1.5%, but the high-frequency tracking is already running above that at 2.5%, while for 2021 we maintain our 2.7% forecast (target is 3.75%). (Please see our report *Scenario Revision: Reaffirming the Recovery but Recognizing the Risks*, September 25, 2020.)**

- **Despite some frustration with the volume of direct investments in the country—although they remain more than sufficient to finance the current account gap—the positive surprise regarding the current account balance and the net inflow of foreign portfolio investments underpinned our perception that external sector data will not become a source of concern.**

- **FGV has released three of the main indexes for September, confirming some of the results expected in last week's preview. Consumer and Construction confidences pointed to growth for the fifth month in a row; despite the decline pointed to in the preview, Retail confidence also posted an increase. Next week, FGV will release the final confidence numbers for Services and Industry. In addition, IBGE and the Labor Ministry are scheduled to release important data on economic activity. Regarding the labor market, data on formal job creation (September 29) and unemployment rate (September 30) will be available for August and July, respectively. Industrial Production for August will also be released, and our projection is now at +3.9 % MoM (s.a.) (-2.2% YoY).**

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- **On the fiscal side, on Tuesday (September 22), the Ministry of Economy published a report on 2020 fiscal accounts. The official estimate of the primary deficit was raised to BRL861 billion (+73.5 billion from July's numbers). The major impact is the Emergency Aid extension of the BRL300 stipend to households until December. Additionally, the release of the report on the Federative Pact (constitutional reform) was postponed again, and we expect a draft to be unveiled next week. We believe that Congress will probably vote on the overturn of several presidential vetoes, with that vote scheduled for September 30. Finally, we believe that the economic team is getting closer to announcing a proposal for a new transactions tax to fund a reduction in the payroll contribution.**

Local markets—FX: This week the Brazilian currency has returned to the USDBRL5.60 vicinity (as of this writing, the USDBRL pair was quoted at 5.57) on the heels of the general sell-off seen around the world as the news cycle these days has raised concerns about an aggravation of the COVID-19 pandemic in Europe, uneasiness about tensions in the US presidential race, and some frustration with recent economic updates. On top of that, as the political debate in Brazil about fiscal issues and macro reforms has not shown any concrete progress lately, market participants remain wary of the prospects for the trajectory of Brazilian public debt, which creates additional pressure on the BRL. As we stated in our report *Scenario Revision: Reaffirming the Recovery but Recognizing the Risks* (September 25, 2020), the strengthening of the BRL that we expect in the coming months hinges on constructive developments on the Brazilian fiscal side. While uncertainties about the commitment of the federal administration to fiscal discipline predominate, we believe that jitters about the international environment tend to amplify the BRL moves.

Local markets—rates: As of this writing (Friday around noon), the weekly change in nominal yields looked poised to reverse part of the bearishness seen in the previous weeks. In the front end, the Jan-22 DI future was standing at 2.82% (-15 bps from last Friday). In the back end, the Jan-27 DI future was trading at 7.18% (-10 bps from last Friday). This week's bull-steepening pattern drove the steepness in this segment to ~434 bps, compared to ~431 bps in the previous week and ~150 bps before the arrival of the pandemic in Brazil (late February).

Despite the global sell-off, it appears to us that successful bond auctions by the National Treasury (i.e. with a good bid-to-cover ratio) allowed some respite. In our view, there is still premia in the back end of the curve, as uncertainty remains on the fiscal side. Ongoing discussions over a new welfare program could provide some direction in the weeks to come (for details, see the fiscal section later in this report). We continue to anticipate volatility and premia for Brazilian assets until we have greater clarity on the fiscal outlook.

Monetary policy: On Tuesday (September 22), the BCB (Brazilian Central Bank) published the minutes from the September 15-16 Copom policy meeting, when the authority kept the Selic rate (at 2.00%, a historical low) for the first time in ten meetings (i.e., since June 2019). Just as in the statement, the Copom minutes were very similar to the previous meeting.

In terms of additions to the recent BCB communications, the highlight from a policy standpoint is that the BCB still sees the conditions in place for the forward guidance to continue. According to the minutes, the Copom "considers that inflation expectations, as well as inflation projections for its baseline scenario, are significantly below the inflation target for the relevant monetary policy horizon; the current fiscal regime has not been changed; and long-term inflation expectations remain well anchored."

The Copom continued to justify the use of this communication as a policy tool, with the idea being "to provide the monetary stimulus deemed adequate to meet the inflation target, but maintaining the necessary caution for prudential reasons." In other words, the commitment to keep the same level of stimulus (under certain conditions) is seen as a complementary policy instrument, given the limitations imposed by the proximity of an effective interest-rate lower bound.

In addition, on Thursday (September 24), the BCB published the 3Q20 inflation report, with details on the BCB's conditional inflation forecasts and some interesting policy-related studies (boxes).

In one of the boxes, the BCB addresses the increasingly controversial gap between the (very high) PPI inflation and (still subdued) CPI inflation in Brazil. The work shows that the authority maintains a calm approach on the subject, by concluding that the mismatch has a lot to do with differences in the composition of each index. The study also highlights that a large part of the divergence comes from fuels. In addition, the authority mentions that the pass-through of higher food costs at wholesale is already making its way to PPIs, with this process still being delayed in industrial goods. The BCB admits the possibility of some additional pass-through in some items, but shows no sign of alarm.

In economic activity, the BCB updates the GDP forecasts for 2020 to -5.0% (from -6.4%). The authority also announced (for a first time) the BCB's forecast for 2021 (+3.9%). In another box, the BCB revisits the discussion about the personal consumption effects from the withdrawal of the emergency aid next year. Despite the reduction in transfers expected for 2021, consumer spending is seen as being supported by the gradual recovery in the labor market and the increase in urban mobility, and the easier access to services that had to be interrupted due to the pandemic. The return of private savings to the pre-crisis level is another factor that could make household spending stronger ahead, according to the BCB.

In terms of inflation forecasts, the interesting new element is that, for different FX and rates assumptions, the BCB's own IPCA projections for 18 months ahead (i.e., 1Q22, a weighted average between the key policy horizons, mainly 2021 but increasingly 2022) point to numbers between 2.8% and 3.4%, below the targets for the relevant horizons (3.75% for 2021; 3.50% for 2022).

In a couple of methodological boxes, the BCB introduces changes in its inflation-modeling process. The authority presents a new model that endogenously estimates some key unobservable variables for monetary policy, such as the output gap and neutral interest rate, as well as inflation expectations. In our view, the results seem to point to a wide-open output gap.

The BCB also announces that from now on, starting from the 4Q20 inflation report, it will start to report inflation projections only for a single FX scenario, assuming stability in the PPP (assuming the inflation target for Brazil and global inflation at 2%). The authority believes this change increases the coherence of longer-term forecasts and avoids a potential underestimation of inflation pressures for longer horizons. The BCB also claims that publishing a single forecast will increase transparency and clarity.

All in all, this week's Copom minutes and inflation report added little new information from a policy standpoint, as the forward guidance has been pretty clear since the last statement. If anything, this reinforces our impression that the BCB is sticking to its flight plan, summarized to some extent by the (conditional) forward guidance of rates at or below 2.00% for the foreseeable horizon, as long as the fiscal regime remains credible, inflation estimates below the target for the short and medium term, and inflation expectations consistent with the target in the long run.

Our baseline scenario contemplates a stable Selic rate at 2.00% all the way until early 2022, when we envision the start of a gradual removal of stimuli and normalization of the policy stance. Importantly, our scenario still has as a key assumption expected compliance with the constitutional spending cap, which plays a decisive role in keeping inflation expectations anchored. In the event that important changes in the fiscal regime take place, putting at risk the (credibility of the) fiscal consolidation process after the pandemic, we believe the conditions for the forward guidance would be breached. In turn, this would impart considerable upside risks for inflation and interest rates for the medium term. We continue to see the fiscal risks as a much more important threat than the current pressures on volatile items, which we still see more as a (temporary) change in relative prices.

Economic activity: In recent days, FGV has released three of the main confidence indexes for September, which have confirmed some of the results published last week in FGV's preview.

Regarding consumer confidence, the headline index continued to increase, pointing to growth of 4.0% MoM (s.a.) and reaching 83.4 points. This result was slightly better than in the preview (82.3), and the index has shown its fifth gain in a row following the sharp drop seen in April. The reading is down by 5% since February (marking the pre-crisis level), meaning that 85% of the points lost between March and April have already been recovered. The headline consumer confidence index was mainly driven by the expectation component, up 5.1%, while the current component pointed to slight growth of 1.5%. In the survey details, the intention to purchase durable goods points to growth of 13.4%, the fifth positive monthly result after April's sharp tumble and surpassing for the first time the pre-crisis level.

In retail sales, despite the decline pointed to in the preview, the headline index posted an increase of 3.1% MoM (s.a.), reaching 99.6 points. This result was considerably better than in the preview (95.4 points), and it was the fifth gain in a row since April's tumble. This figure was mainly driven by the current component, up 4.5%, while the expectation component pointed to an increase of 1.2%. The headline number is down by only 0.2% since February (marking the pre-crisis level), meaning that virtually the entire drop registered between March and April has already been recovered. This composition suggests a favorable perception regarding sales in the current month but with a cautious view in relation to the coming months, as the emergency aid will be reduced and the labor market conditions will likely continue to deteriorate.

In construction, the numbers point to the continuation of a gradual recovery in the sector, with the headline rising 4.2% MoM (s.a.) to 91.5 points, a better result than in the preview (90.4). This was the fifth gain in a row, and the headline is

-1.4% below February's reading, which means that 98.1% of the drop has already been recovered. This figure was mainly driven by the current component, up 5.6%, while the current component pointed to growth of 2.9%. In the details, the expected demand index points to growth (of 3.0%) for a fifth month running.

All in all, the first numbers for September suggest a gradual "normalization" of economic activity, in line with the trend observed up to now.

Fiscal policy: On Tuesday (September 22), the Ministry of Economy published a report on 2020 fiscal accounts. The official estimate of the primary deficit was raised to BRL861 billion (+BRL73.5 billion from July's numbers). The official deficit is not far from our estimated BRL880 billion (12.6% of GDP). Total expenses increased by BRL63.3 billion, basically incorporating the Emergency Aid extension of a BRL300 stipend per month to households until December. Total expenses should now reach BRL2.04 trillion this year, according to the government's forecast, up from BRL1.44 trillion in 2019. On the revenue side, the revision is BRL9.7 billion lower than the government estimate in July, considering the impact of tax deferrals and the use of credit tax compensation. In general, these numbers continue to show the effects of the pandemic on fiscal accounts.

Additionally, the release of the report on the Federative Pact (constitutional reform) was postponed again. The government is continuing discussions seeking a way to finance a new welfare program through this reform, but they have not yet reached a consensus on the fiscal measures to curb mandatory expenses. The rapporteur of the Federative Pact promised to announce his draft of the proposal in the coming weeks; if there is an agreement on the Federative Pact proposal, we think it will likely be presented at the beginning of next week. We believe Congress probably will vote on the overturn of several presidential vetoes, with those votes scheduled for September 30. The focus will be on the one extending the payroll tax exemption to 2021, which could mean less revenue and slightly reduce the margin for complying with the spending cap for 2021. Finally, we believe that the economic team is getting closer to announcing a proposal for a new transactions tax to fund a reduction in the payroll contribution.

Inflation: September's IPCA-15 registered a 0.45% MoM change (2.65% YoY). The result was a bit above the market's median expectation (0.39%) and also our forecast (0.40%).

The upside surprises were concentrated in free prices (+9 bps). The food-at-home group rose 1.96% MoM (+13.0% YoY), while we expected it to rise 1.72% MoM. The divergence contributed +3 bps to the actual headline result number compared with our estimate. On services there was also a small upside surprise (+2 bps), partly related to some pass-through from food-at-home to food service. Still, the services group rose only 0.07% MoM (meaning -1.8% MM3saar). Industrial goods also surprised to the upside, rising 0.29% MoM, while we expected 0.13%. Finally, on administered prices the surprise was to the downside, contributing -4 bps to the headline forecast error—most of the surprise was related to gasoline. The new average of core measures (EX0, E3, DP, MS, and P55) registered a 0.12% MoM change, with the annualized (and seasonally adjusted) three-month moving average reaching a muted 1.9%, whereas the target for 2020 is 4.0%.

We recently revised our official forecast for IPCA for 2020 to 2.3% from 1.5% in June (please see our report *Scenario Revision: Reaffirming the Recovery but Recognizing the Risks*, September 25), but our high-frequency tracking is already running above that, at 2.5%. The revision was concentrated on food-at-home, where we increased our forecast to 12.6% at year-end, and industrial goods, for which we raised our forecast to 0.9% at year-end (mainly because of apparel). It is worth noting that we continue to envision upside risks for 2020.

On food-at-home, there is still a backlog of increases in producer/wholesale prices to reach consumers in an environment of upward seasonality, high external and domestic demand, and income support (government emergency aid). We have said in previous reports that we cannot rule out numbers closer to 14-15% by year-end. On industrial goods, there could be a stronger rebound, as the economy continues to open up, income is still supported by government aid, and the BRL is still depreciated. That is, possibly repressed demand for some goods could find a (temporary, in our view) supply shortage in some specific industries (as is being flagged by some news reports) that also had an increase in costs (BRL depreciation). On services, the upside risk is less relevant, as repressed demand is less likely to occur given the nature of the sector. However, the point here is that there seems to be space for a rebound (with the economy more open and income still supported) than for further deepening of the disinflation process during the last months of the year. As a first preliminary signal, the most recent reading (IPCA-15 on September 23) showed the MM3saar making a first tick upward. Finally, on administered prices we see downside risk for gasoline prices, but we have less conviction here.

Looking ahead, however, we continue to see a benign scenario for 2021 inflation. First, we see food-at-home inflation decelerating next year. Second, for industrial goods and services, the economy will be less affected by the normalization of the lockdown process and there will be no income support from the government (in our baseline scenario)—in other

words, once pandemic-related noises fade, we expect the wide negative output gap to play its part to keep inflation low. Finally, for administered prices we already anticipate pressure given the reimposition of tariffs that have been postponed this year, so this upward pressure is already mapped in our forecasts. This inflation composition is benign, meaning that core measures will continue on a moderate path (running at low levels) and allow for monetary policy to continue to stimulate the economy, while fiscal policy is constrained by the long-term adjustment (particularly the "spending cap" rule). We are keeping our 2021 inflation forecast at 2.7% and have reduced our 2022 forecast to 3.2% from 3.5%. (Please see our report *Scenario Revision: Reaffirming the Recovery but Recognizing the Risks*, September 25, 2020).

Balance of payments: The USD3.7 billion surplus registered by the current account balance (CAB) in August 2020 was far above our estimate of a USD1.7 billion surplus, as well as north of the ceiling of the range of market estimates (USD3.0 billion). This number reinforced our perception that external sector data will continue to improve as the CAB three-month moving average seasonally adjusted annualized result continued to suggest a steeply upward trend compared with the recent past (from a nearly USD70 billion annual deficit in February to a USD34 billion surplus currently). The same picture can be seen in the evolution of the deficit in 12-month-to-date terms, as it declined to USD25.4 billion last month from USD50.9 billion in December 2019.

Regarding financial flows, although direct investments in the country have remained on a downward trend (to USD54.5 billion currently from USD73.5 billion at the end of last year in 12-month-to-date terms, which is still much higher than the current account deficit), foreign portfolio investments in the domestic market have registered a net inflow for the third month in a row. We expect direct investments to resume an upward trend as the economic recovery and the commitment to fiscal discipline become clearer; at the same time, we think the inflow in foreign portfolio investments indicates that the bulk of the adjustment in the portfolio of Brazilian financial assets held by foreigners has already taken place, which reinforces our assessment that external sector data should not be blamed for the negative dynamics of the BRL.

Next week: On the macro agenda, several numbers are scheduled to be released. FGV's confidence data for Industry and Services will be published on Monday (September 28) and Tuesday (September 29), respectively. If the preview's data is confirmed, Industry confidence will be at the highest level since June 2013. Regarding the labor market, formal job creation (September 29) and the unemployment rate (September 30) will be available for August and July, respectively. These figures will be essential for tracking the deterioration in labor market conditions amid a gradual reopening of the economy. Industrial production data for August will also be released (October 02), and our projection is now at 3.9% MoM (s.a.) (down 2.2% YoY). If confirmed, this will be the fourth gain in a row, with the headline reading down by -2.3% since February and with 91.6% of the drop registered already recovered.

September's IGP-M will be released on Tuesday (September 29, 2020) and we forecast it will accelerate further to 4.60% MoM (18.2% YoY), still driven by wholesale prices (both agro and industrial).

On the fiscal side, the Brazilian internal revenue service will publish the federal tax collection information for August 2020. Our estimate is BRL112.3 billion, which would mean a contraction of ~9% compared to August 2019, in real terms. The performance of tax collection has been recovering gradually, driven by the better performance of economic activity. Even so, the result is still affected by temporary tax relief measures and deferral of tax collection announced by the federal government to mitigate the economic blow of the COVID-19 crisis.

Based on this tax revenue data, we estimate that the central government's primary deficit will have totaled BRL92.6 billion in August 2020 (this data is due out next Tuesday, September 29). In addition to shrinking tax collection, we highlight the impact from the substantial expansion in primary spending to combat the COVID-19 crisis, which added to BRL93.1 billion in August. In turn, next Wednesday (September 30) the BCB will publish the consolidated public sector's fiscal balance for August 2020, which encompasses the federal government, regional governments, and state-owned companies. We anticipate a monthly primary deficit of BRL87.1 billion, with the following breakdown: -BRL92.1 billion for the federal government; +BRL4.5 billion for states and municipalities; and +BRL0.5 billion for state-owned companies.

Next Thursday (October 1, 2020), the Foreign Trade Secretariat (dubbed SECEX) is due to release the trade balance for September 2020, and we project it to show a USD7.1 billion surplus on the heels of USD19.4 billion in exports and USD12.3 billion in imports in September. If our forecasts prove right, the average of the last three months (in seasonally adjusted terms) should indicate a USD86.4 billion annual surplus. Moreover, if that turns out to be accurate, the seasonally adjusted daily averages of imports will have outpaced that of exports for the second month in a row, which buttresses our view that a recovery is on the way that is likely to result in a smaller trade balance as time goes by (our forecast is USD59.7 billion for 2020).

MACRO AGENDA

Indicator	Date	Estimate	Prior
Industrial Confidence Survey FGV Sep/20 - Points	Mon,28-Sep	-	98.7
Outstanding Loans Aug (%MoM)	Mon, 28-Sep	1.5	1
Total Outstanding Loans Aug (BRL billion)	Mon, 28-Sep	3.7	3.66
Personal Loan Default Rate Aug %	Mon, 28-Sep	3.6	5.1
Federal Debt Total (BRL billion) Aug/20	Mon, 28-Sep	4.696	4.345
Services Confidence Survey FGV Sep/20 - Points	Mon, 28-Sep	-	85.0
IGP-M inflation (% MoM)	Tue, 29-Sep	4.60	2.74
IGP-M inflation (%YoY)	Tue, 29-Sep	18.23	13.02
PPI – Manufacturing (%MoM)	Tue,29-Sep	-	2.67
PPI – Manufacturing (%YoY)	Tue, 29-Sep	-	10.84
Central Govt Budget Balance Aug/20 (BRL billion)	Tue,29-Sep	-92.6	-87.8
Formal Job Creation (CAGED) Aug/20	Tue,29-Sep	-	131k
National Unemployment Rate (PNAD) Jul/20 (% NSA)	Wed, 30-Sep	-	13.30
Net Debt Aug/20 % GDP	Wed, 30-Sep	62.1	60.2
Primary Budget Balance Aug (BRL billion)	Wed, 30-Sep	-87.1	-81.9
PMI Manufacturing Sep/20	Thu, 01-Oct	-	64.7
Trade Balance Monthly Aug/20 (USD billion)	Thu, 01-Oct	7.1	6.6
Exports Total Sep/20 (USD billion)	Thu, 01-Oct	19.4	17.74
Imports Total Sep/20 (USD billion)	Thu, 01-Oct	12.3	11.13
Vehicle Sales Fenabrave Sep/20 - Units	Thu, 01-Oct	-	183k
FIPE CPI Sep (% MoM)	Fri, 02-Oct	-	0.78
Industrial Production Aug (% MoM)	Fri, 02-Oct	3.9	8.0
Industrial Production Aug (% YoY)	Fri, 02-Oct	-2.2	-3.0

Sources: Bloomberg and Santander.

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