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Macroeconomic Research

BRAZIL MACRO

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MACRO COMPASS

VISITING NEW HIGHS (ON COVID-19, INFLATION AND FISCAL UNCERTAINTIES)

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- Amid a lack of surprises (with implications for Brazilian markets) from abroad, and despite a noisy fiscal and political news cycle in Brazil recent days, the BRL ended March 31 close to where it was on March 25, outperforming peer currencies' average in the period. Nonetheless, uncertainties surrounding the feasibility of implementing the budget this year led the nominal yield curve to steepen slightly as compared to March 25.
- New COVID-19 cases appear to have peaked, as the vaccination process keeps gaining traction, recently reaching a daily average of ~673k. Casualties, however, continue to surge, with 17 states still reporting ICU occupancy rates above 90%. On the fiscal side, the budget results have been positive for the first two months of the year, hence a "good scene in "the movie" (yearly results) that, however, could be affected by increased government expenditures to mitigate the effects of the pandemic. In addition, the government is seeking to overcome the 2021 budget gridlock.
- The IBGE's National Household Survey (PNAD) indicated that the unemployment rate stood at 14.2% in the three months to January and indicated worsening conditions in the labor market, while CAGED survey showed that net formal job creation stood at +401.6k in February 2021, a new all-time high. In our view, the labor market remains precarious, and PNAD paints a more precise picture of current conditions.
- In February, industrial production surprised negatively, decreasing 0.7% MoM-sa, well below the market expectations (+0.5%), and breaking a string of nine gains in a row. In comparison to the pre-crisis mark (Feb-20), industrial production is still 2.8% above it.
- Brazil Central Bank (BCB) data for February 2021 shows that non-earmarked credit to households rebounded from the January drop. However, recent restrictions spurred by the pandemic's worsening are likely to weigh on March 2021 figures, in our view. Importantly, both the debt-to-income and debt service ratios for households have been rising fast — a risk for delinquencies and credit supply as the economy recovers.
- We estimate March's IPCA to have accelerated sharply in monthly terms to +1.08% (+6.26% YoY) vs. +0.86% MoM (+5.20% YoY) in February 2021, meaning a high seasonally adjusted print. The EX3 core gage should have remained at a high level in a 3mma-saar basis, thus reinforcing the unfavorable scenario for inflation in the short term.

Most of the information in this report is up to the end of Wednesday, March 31, 2021.

Figure 1. Brazil Macro Agenda for the Week of April 05-09, 2021

Indicators	Source	Reference	Date	Santander Estimate	Prior
PMI Composite	Markit	Mar-21	Tue, 06-Apr	--	49.6
PMI Services	Markit	Mar-21	Tue, 06-Apr	--	47.1
IGP-DI Inflation (% MoM)	FGV	Mar-21	Wed, 07-Apr	2.50	2.71
IGP-DI Inflation (% YoY)	FGV	Mar-21	Wed, 07-Apr	31.05	29.95
Vehicle Production (thousands)	Anfavea	Mar-21	Wed, 07-Apr	--	197
IPCA Inflation (% MoM)	**IBGE**	**Mar-21**	**Fri, 09-Apr**	**1.08**	**0.86**
IPCA Inflation (% YoY)	**IBGE**	**Mar-21**	**Fri, 09-Apr**	**6.26**	**5.20**

Source: Santander Brazil.

For details on Santander's economic forecasts for Brazil, please refer to our last scenario review[1].

[1] **Santander Brazil - Macroeconomic Scenario: *"Anchoring Power Is Dwindling"* –** April 1, 2021- Available on: http://bit.ly/Std-scenario-Apr21

LOCAL MARKETS—FX

In the last trading session of 1Q21, the USD/BRL pair ended at 5.63, thus outperforming the average behavior of peer currencies but not changing much from the 5.65 level observed on March 25–reference date for the last edition of this report. Despite appreciating in the period, it is worth noting that the move was chiefly observed on March 31.

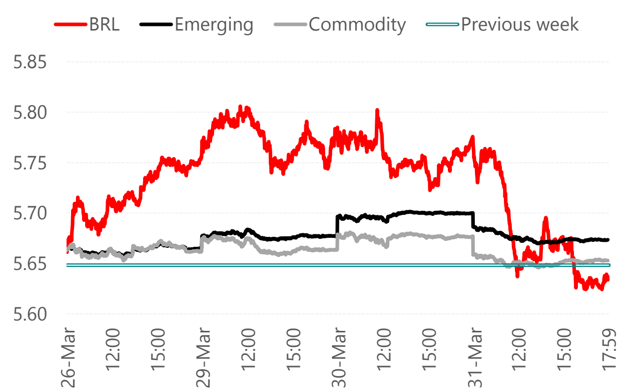
In our view, the international front had little to do with this pattern as, except for news related to a hedge fund defaulting on margin calls, subsequently hitting some banks with big losses, there was no major change in recent trends. The U.S. and China continue to provide promising signals that their economic recovery is gaining strength, while the Eurozone continues to lag behind. Unsurprisingly, the discrepancy between these economies continued to hinge on the different levels of immunization that their populations currently have.

On the domestic side, the pandemic outlook has also continued to weigh on the performance of Brazilian assets, but political and fiscal concerns shook the FX market earlier this week. Cabinet reshuffling and the difficulties related to the federal budget for 2021 recently-approved in Congress raised some concern among market participants at first (more details in the Fiscal Policy section). However, in our view, market participants ultimately have taken this reshuffling as a sign of a better coordination between the executive and legislative branches. Additionally, the first signs of adjustment in some controversial budget proposals have also helped reverse negative initial impressions in the market and opened room for the appreciation of the currency on March 31.

LOCAL MARKETS—Rates

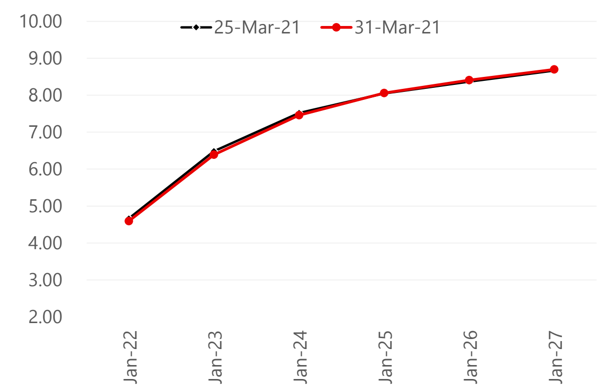
The nominal yield curve steepened a little more. Since our last report (March 25), the front end of the curve (Jan-22 DI future) fell 7 bps to 4.60%, while the back end (Jan-27 DI future) rose 3 bps to 8.70%. Hence, the steepness in this segment increased from 401 bps to 411bps since Thursday of last week (March 25). At the front end, the market made a slight reduction of the probability of a more *hawkish* move by the BCB for next interest rate decision, as recent communications reinforced the BCB's intention to make a "partial adjustment" of the monetary stimuli. At the long end, we think the driver continues to be the fiscal risk and recent uncertainties regarding the feasibility of implementing the public budget set for this year affected negatively this part of the curve.

Figure 2.A. – USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note1: As of the close Wednesday, March 31, 2021.
Note2: For other currencies, we use USDBRL values as a base-index

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



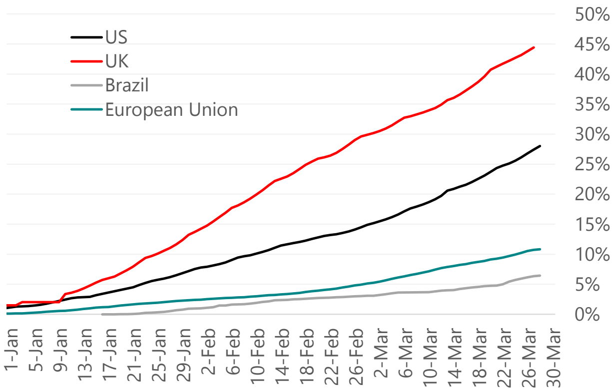
Sources: Bloomberg, Santander.
Note: As of the close Wednesday, March 31, 2021.

COVID-19 MONITORING

In the U.S., while new cases are rising at the margin, curves of casualties and hospitalizations are flat. The vaccination pace is currently at 2.7 million/day (7-day moving average), with nearly 28% of the population having received at least one dose. This figure stands at 44% in the U.K. and 10% in the European Union. Cases are falling in Italy, and starting to bend in Germany and France. In U.K., the downward trend persists, so the reopening scheme should follow as planned.

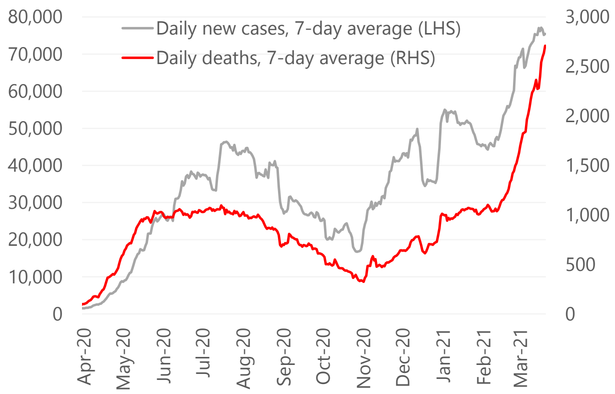
In Brazil, new cases of COVID-19 seems to have peaked, with death toll still very high (and still rising). Last Saturday (March 27, 2021), the new daily cases (7-day moving average) reached 77,129, the highest since the beginning of the pandemic. The ICU occupancy rate is still above 90% in 17 states at least. Nonetheless, in São Paulo state, the ICU occupancy rate looks poised for a flattening, in our view. As of Wednesday (March 31, 2021), 22.4 million doses (out of 43 million available) had already been administered in the country, with the most recent pace of vaccination standing at 673k/day (7-day moving average). Data from Brazil's Health Ministry reported an average of 75k new daily cases (7-day moving average) as of Wednesday (March 31, 2021), the same from last week, while daily casualties (7-day moving average) stood at 2,710, up 14.6% 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 Health Ministry, Santander.

FISCAL POLICY AND POLITICS

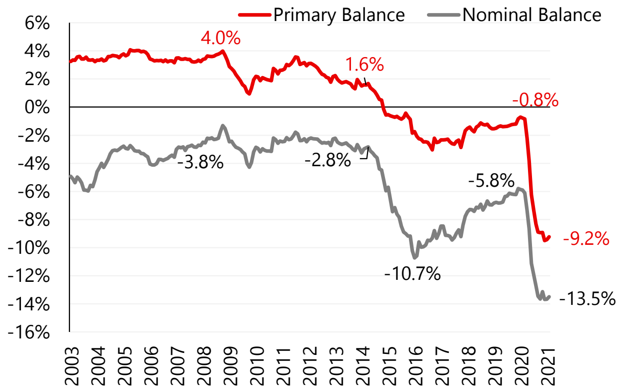
According to data BCB published on March 31, the consolidated public sector posted a primary deficit of BRL11.8 billion in February, better than our forecast (BRL19.4 billion) and the market's median estimate (BRL20.0 billion). The deficit reached BRL691.7 billion (9.2% of GDP) in the 12-month reading. The government's primary target for the year is currently at BRL247 billion (3.2% of GDP). The 12-month nominal deficit was BRL1.01 trillion (13.5% of GDP). In the first two months of the year, the consolidated public registered the best result in the BCB series (since 2002). the results of the public accounts were positive, showing a good scene. However, we believe that yearly results (the movie) could be affected by increased public expenditures to mitigate the effects of the pandemic—the resumption of Emergency Aid will already add BRL44 billion in disbursements between April and July.

Since 2013, this was the best result for central government for the first two months of a year. A key factor was the lower level of discretionary spending, which was 36% lower than in 2020 in real terms. The disbursement was only 1/18 of the budget for these expenses in 2021—since the final budget has not yet been approved during this period. In February, the main surprise once again was regional governments' results (+BRL10.5 billion compared to +BRL4.9 billion in February 2020). In 12 months, regional governments posted a primary fiscal surplus of BRL48.7 billion (0.65% of GDP)—the best result since June 2012. In our view, regional governments' better results will be short lived. These results were probably affected by the impact of the transfers and the solid GDP performance of 4Q20—which improved tax collection.

Gross debt reached 90.0% of GDP in February 2021, an increase of 0.6 p.p from January 2021. Meanwhile, net debt was 61.6% of GDP, 0.2 p.p higher on the same basis of comparison. We expect gross debt to fall, however, assuming that the BNDES will repay the Treasury at least BRL100 billion and also that the government will comply with the spending cap. Another positive factor for the debt to GDP ratio will be the increase in nominal GDP, considering the inflation shock on the deflator. See link below[2].

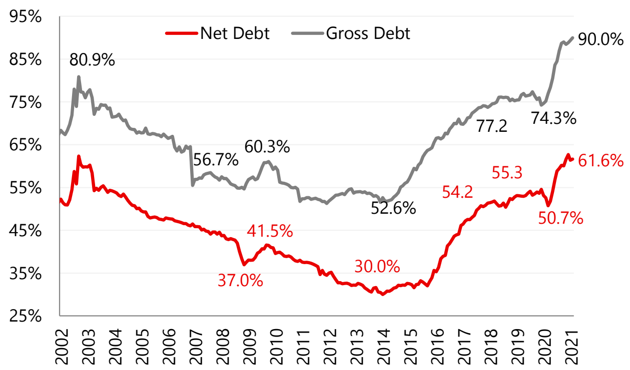
Last week, the Brazilian Congress approved the federal budget for 2021. The final version brought some changes to the economic team's proposal. Approximately BRL26 billion in mandatory expenses were shaved off without technical support or prior legal approval. Besides that, the first bimonthly budget report (a requirement imposed by the Fiscal Responsibility Law) had already pointed out the need to raise the forecast for mandatory expenses by BRL17.6 billion. Now, any adjustment in the spending composition will have to occur either by presidential veto, supplementary budget (*crédito extraordinário*), or a freezing of discretionary outlays, which usually creates friction in the relationship among ministries, Congress, and other government branches, with ensuing political consequences. The government is seeking to overcome this budget gridlock. If the 2021 budget is not amended, we believe the government may witness the shutdown of some public services in the coming months so as to comply with fiscal rules. The executive branch has until April 9 to come up with a solution to this stalemate.

Figure 4.A. – Consolidated Public Sector (12m % GDP)



Sources: Brazilian Central Bank, Santander.

Figure 4.B. – Public Sector Debt (12m % GDP)



Sources: Brazilian Central Bank, Santander.

[2] **Santander Brazil Fiscal - *"A Good Scene from a Movie Yet to Come"* –** March 31, 2021 - Available on: https://bit.ly/Sant-fiscal-mar21

ECONOMIC ACTIVITY

According to the IBGE National Household Survey (PNAD), the unemployment rate reached 14.2% in the three months to January, below our forecast (14.6%) and slightly above market consensus (14.0%), a rise of 3.0 p.p. in comparison with the year-ago level. We estimate that the seasonally adjusted unemployment rate rose to 14.7% in January, from 14.6% in December. Both the labor force and employed population had drops at the margin. The -0.2% variation in employment more than compensated for the -0.1% fall in the labor force, which explained the slightly higher unemployment rate and points to a still fragile labor market. Labor market participation rate, which has recovered somewhat in the past few months, has once again dropped at the margin. The seasonally adjusted figure stood at 56.0% in January, from 56.2% in December. The effective real wage bill has worsened additionally in December (data lagged one month relative to other PNAD series), with a 11.1% YoY drop.

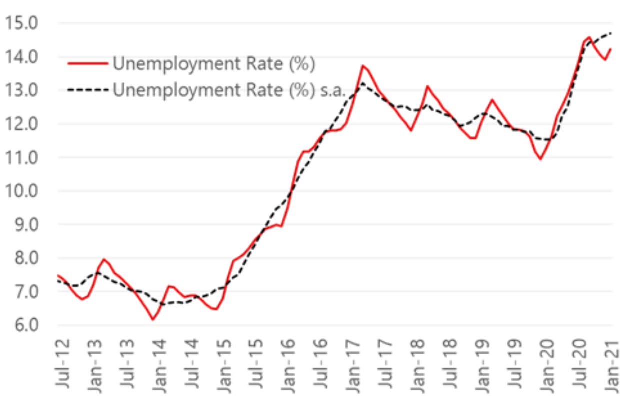
The February 2021 CAGED survey showed that net (unadjusted) formal job creation stood at +401.6k, considerably better than market consensus (+255k), our estimate (+280k), the month's historical average (+117k) and the all-time record for the month (+281k in 2011). After a seasonal adjustment, net formal job creation increased to 331.7k, from 254.2k in January. It is important to note that, with the February result, all the main economic sectors in CAGED have fully offset the job losses suffered during the pandemic.

Despite the one-month lag between CAGED and PNAD surveys due to the pandemic, most recent data has shown more stark differences in the results. We maintain our view that the CAGED survey may be underreporting layoffs, leading to artificially high net job creation numbers. We highlight that this difference cannot be attributed to the coverage of each survey, since the data on formal workers within the PNAD still is considerably different from what CAGED has been reporting (Figure 9.B).

We maintain our view of a precarious labor market situation. As new mobility restrictions took place in March and April, employment should suffer further impacts, and even the CAGED data should indicate some deceleration in the coming months. See link below[3].

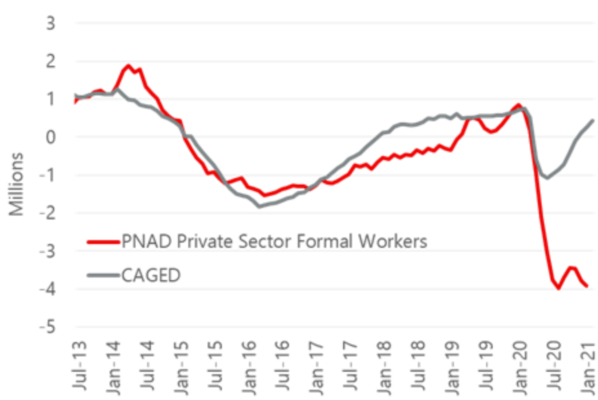
Still assessing February 2021 activity indicators, we saw that industrial production registered a decrease of 0.7% MoM-sa in the period, breaking a string of nine gains in a row. Despite this negative figure, the sector is still 2.8% above the pre-crisis mark (February 2020). We had expected industrial production to have been supported in 1H21 by an inventory replenishment process, despite lower demand for industrial goods. However, the widespread shortage of inputs and the relapse of the pandemic will compromise the performance of domestic factories in the coming months.

Figure 5.A. – Unemployment Rate (% of labor force)



Sources: IBGE, Santander.

Figure 5.B. – Net Job Creation (12m)



Sources: IBGE, CAGED, Santander.

[3] **Santander Brazil Labor Market - *"PNAD Slows Down, CAGED Speeds Up"* –** March 31, 2021 - Available on: http://bit.ly/Sant-labor-Mar21

BANK LENDING

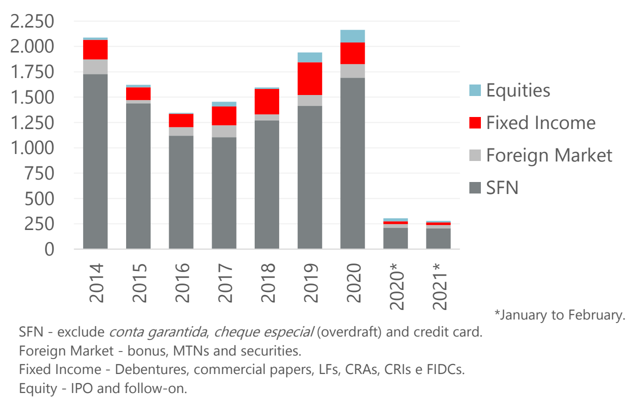
Total outstanding loans in the National Financial System (SFN) posted inflation-adjusted growth of 10.3% YoY in February (BRL4.0 trillion), up 5.7% YoY for households and 16.8% YoY for non-financial corporations. In the non-earmarked segment, household portfolios grew 4.7% YoY (inflation adjusted) in February. For corporations, growth in the balance of non-earmarked loans continued to be high (+16.4% YoY), with an emphasis on working capital (+41.9% YoY, inflation adjusted). In the earmarked segment, growth for households reflects real estate financing (+12.3% YoY, inflation adjusted), while the increase for companies is due to the emergency credit-support programs (e.g., *Pronampe*, PEAC).

New loans adjusted for inflation and seasonality (Central Bank of Brazil methodology) rose 5.1% in the month, a significant increase from January (+1.5% MoM-sa). For households, the non-earmarked segment saw an increase of 5.8% MoM-sa in February, driven by overdrafts, payroll-deducted personal loans for retirees and pensioners, and vehicle financing. In the earmarked segment, real estate financing remains high (+55.1% YoY), as financial conditions are favorable. For companies, there was an increase of 1.7% MoM-sa in the non-earmarked segment, with working capital rebounding at the margin. In the earmarked segment, February saw an increase of 47.7% MoM-sa. Despite the slowdown in these pandemic-related types of credit as economic activity recovers, a new round of BRL16 billion in *Pronampe* credit support is expected in the coming months.

Considering total corporate financing (new loans in the SFN, debt and equity issues in the capital markets) in 2021 (through February), compared to same period of 2020, issuances in the capital markets are 32% lower, while SFN concessions are down 3%. As a result, total corporate financing is down 9% compared to the year-ago period.

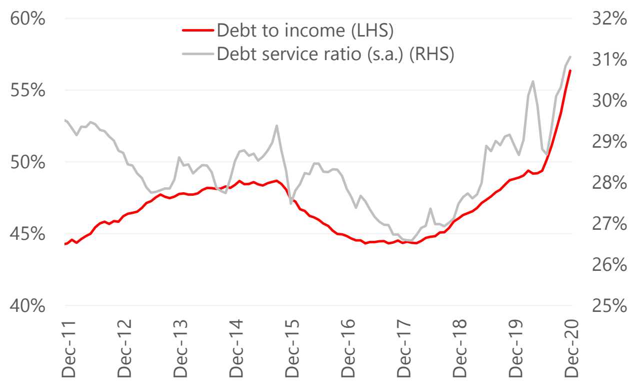
In non-earmarked loans, the seasonally adjusted default rate (% of 90-day past-due loans) came in at 4.1% and 1.6%, respectively, for households and corporations, stable versus January. **Importantly, both the debt-to-income and debt service ratios for households have been rising fast, a risk for delinquencies and credit supply as the economy recovers.** See link below[4].

Figure 6.A. – Total Corporate Financing (BRL billion, Inflation Adjusted)



Sources: Brazilian Central Bank, Anbima, Santander.

Figure 6.B. – Consumer Indebtedness (% of Expanded Aggregate Wages)



Sources: Brazilian Central Bank, Santander.

[4] **Santander Brazil Credit - *"A (Partial) Rebound in February"* –** March 29, 2021 - Available on: http://bit.ly/Sant-credit-290321

INFLATION

We expect IPCA data to show a sharp acceleration in March 2021 on a monthly basis. In a month in which the inflation seasonal pattern usually points to a deceleration, IPCA March—slated for Friday (April 9, 2021)—should show a +1.08% MoM (+6.26% YoY) change vs. a +0.86% MoM (+5.20% YoY) reading in February 2021, thus reaffirming the unfavorable short-term scenario for inflation. This should be the highest YoY since 2016. The strongest pressure should come from regulated prices (+2.97% MoM), with the inflation in fuel prices (+12.00% MoM) being a major driver and responsible for more than a half of the headline variation. Industrial goods should also continue their upward trend and post a +1.28% MoM change–a higher print than the previous reading, which should have pressured core inflation measures. On the other hand, services should decelerate considerably, to +0.07% MoM from +0.55% MoM in February 2021, as the impact from tuition fees should have faded away. Additionally, on the bright side, inflation in the *Food-at-home* group should also decelerate in monthly terms to +0.02% from 0.28% in the previous reading—although we believe this retreat is close to an end. In April 2021 we should already see another acceleration of food inflation.

In terms of underlying inflation measures, the EX3 core should rise around +0.47% MoM, as per our projections, meaning a stable trend (3mma-saar) at a considerably high level (in our view) - around 5.8% - thus reinforcing the unfavorable outlook for inflation in the short term.

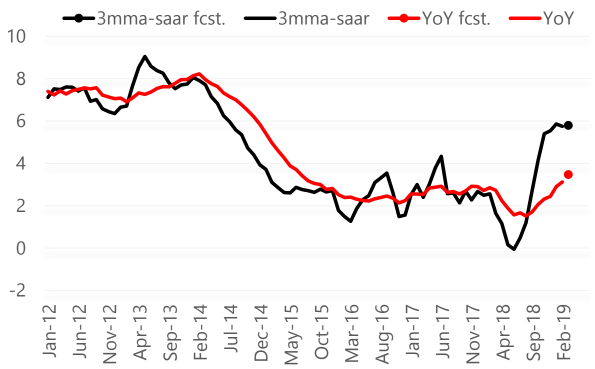
Looking ahead, despite an economy that keeps running well below its potential (especially in the services sector), we believe cost/supply related issues will put considerable upward pressures on IPCA 2021 inflation and our official forecast has just been revised to where our high frequency tracking was hovering, namely, 5.0% for IPCA 2021. For IPCA 2022, we still believe that pandemic-related noises should have ended by then and the effect of the low demand will prevail in prices dynamics. However, we also revised IPCA 2022 upwards to 3.7% (from 3.2%), considering a spillover of recent shocks to next year. See link below[5].

Figure 7.A – IPCA Monthly forecast (%)

	MoM		YoY	
	Mar-21	Contr.	Feb-21	Mar-21
IPCA	1.08	1.08	5.2	6.3
Administered	2.97	0.76	3.8	7.1
Free	0.44	0.32	5.7	6.0
Food-at-home	0.02	0.00	19.4	17.8
Industrial goods	1.28	0.30	4.6	6.0
Services	0.07	0.03	1.4	1.6
EX3 Core	0.47	0.47	3.1	3.5

Sources: IBGE, Santander.

Figure 7.B. – Core Inflation forecast (IPCA EX3, %)



Sources: IBGE, Brazilian Central Bank, Santander.

[5] **Santander Brazil Scenario Review - *"Anchoring Power is Dwindling"* –** March 31, 2021 - Available on: http://bit.ly/Std-scenario-Apr21

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