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Brazil Macro Compass

When November Ends

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- **We believe that the BRL is likely to end the week as the best performer among emerging currencies, amid a relatively constructive news cycle abroad, on the heels of less perceived uncertainty regarding the U.S. presidential race and a new round of fiscal stimulus expected at some point in the future. At the local level, there was some respite following signs that politicians will try to keep a new welfare program within the constitutional spending cap. We continue to see the fate for FX (and other Brazilian asset classes) closely connected to the credibility of the current fiscal regime.**

- **Following nearly the same drivers, as well as a more cautious placement of duration in the market by the National Treasury in this week's bond auction, the local yield curve has bull-steepened this week, reversing part of the bearishness seen recently. In our Tuesday, October 6 report, *Mind the (Fiscal Risk) Premium*, we presented our estimates and a discussion on Brazilian government bonds' hefty premium.**

- **The IBGE released the retail sales data this week, confirming the market's expectations of another gain in August. Following the upward trend anticipated by our proprietary coincident index (IGet), the headline core index pointed to growth of 3.4% MoM s.a. (6.1% YoY), above market consensus projection (3.0%). The headline broad retail sales number (including auto and construction) rose 4.6% MoM s.a. (3.9% YoY). Retail sales gauges are now running at levels considerably above the ones seen before the crisis, on the heels of a temporary boost provided by pandemic-related transfers to households.**

- **Next week, IBGE and the Brazil Central Bank (BCB) are scheduled to release services volume and the monthly activity index (IBC-Br). We project gains of 1.9% MoM s.a. (-11.4% YoY) and 1.3% MoM s.a. (-4.7% YoY), respectively. Based on the available data, our tracking for 3Q20 GDP is running at 8.7% QoQ s.a. (-3.5% YoY), implying a significant recovery 2Q20's steep fall.**

- **On the fiscal side, discussions around the creation and funding of a new welfare program came to a halt this week and will not resume until municipal elections are held at the end of November. Considering the headwinds for debt, on Wednesday, October 7 we published a report (*Borrowing Requirements and Debt Management: The Importance of the Fiscal Adjustment*) analyzing the impact of heightened fiscal risks from the standpoint of debt management.**

- **September's IPCA registered a 0.64% MoM change (3.14% YoY), considerably above the market's median expectation (0.54% MoM) and our forecast (0.56% MoM). Given this upside surprise, we revised our IPCA 2020 high-frequency tracking a bit further upward, from 2.8% to 3.0% (versus the official forecast of 2.3%), but we keep our 2021 forecast unchanged, at 2.7% (see our report published earlier today for details: *Brazil Macro: IPCA Inflation -- More Pressure for 2020, but a Benign Scenario Still Expected for 2021*).**

Local markets—FX: This week financial markets interpreted recent electoral surveys in the U.S. as indicating a reduced likelihood of disputed results, thereby increasing the possibility of further fiscal stimulus in the world's largest economy, in our view. Thus, we believe the international environment provided fuel for most emerging market currencies to strengthen this week–although following a still volatile pattern. Perhaps a reflection of its high-beta pattern, the BRL was (at the time of writing, Friday, around noon, local time) about to end the week not only stronger than a week ago (as of this writing the USDBRL pair was quoted at 5.54 versus 5.69 last Friday), but also standing as the best-performing currency for the week (among the majors).

On top of the relatively favorable external environment, the domestic news cycle regarding the fiscal outlook for the coming years has (seemingly, in our opinion) helped the currency move, the reason being intensifying debates toward a solution to provide funding sources for a new welfare program within the budgetary limits imposed by the spending cap rule. As indicated by congressional representatives involved in the shaping of this legislation, announcements will not be made until only after municipal elections are held at the end of November. We believe that the search for means to comply with the current budget framework is a sign that politicians have understood the necessity to return to a strict fiscal discipline next year (to be seen).

We may well see some volatility in the coming weeks as the suggestions to solve the predicament become public. However, a formal proposal for the welfare program and the savings necessary to keep it within the constitutional ceiling will be left for December and, according to our key hypothesis that the current fiscal framework remains intact, the BRL should strengthen as we approach the end of the year.

Local markets—rates: At the time of writing (Friday, around noon, local time), the weekly change in nominal yields looked poised to reverse some of last week's bearishness. In the front end, the Jan-22 DI future was standing at 3.17% (-23 bps from last Friday). In the back end, the Jan-27 DI future was trading at 7.49% (-11 bps from last Friday). This week's bull-steepening pattern drove the steepness in this segment to ~432 bps, compared to ~420 bps in the previous week and ~150 bps before the arrival of the pandemic in Brazil (late February).

From a technical standpoint, it appears to us that the National Treasury's successful bond auction on Thursday (following the decision to reduce maturities in the offer) contributed to providing some relief to nominal rates. From a macroeconomic perspective, local news probably favored such a respite in the yield curve, as the markets apparently enjoyed the political signs that a new welfare program will mean no breach of fiscal discipline. Lastly, from a financial point of view, the local yield curve also seems to have been influenced by the global risk-on sentiment in recent days.

In our October 6 report, *Mind the (Fiscal Risk) Premium*[1], we present estimates and discuss on the hefty premium in Brazilian assets (particularly government bonds), based on the gap between the yield curve and consensus forecasts. Overall, we estimate that, as of October 2, 2020, the nominal interest rate premium at ~80 bps for the 1-year, ~170 bps for the 2-year, ~260 bps for the 5-year, and ~280 bps for the 10-year, topping the historical average (since 2010). For the same date, we calculate the inflation premium at ~120 bps for the 1-year, ~90 bps for the 2-year, ~110 bps for the 5-year, and ~80 bps for the 10-year, also above the historical average (since 2010). In general, the estimated premium stands between the low values seen months before the pandemic began and the high levels seen in previous periods of stress, such as in 2015 and 2018.

We take the high premium as an indication that while the baseline scenario (of fiscal convergence) continues to be the likely outcome perceived by analysts, the probability that alternative scenarios (of fiscal dominance) could materialize has risen lately, according to market participants. We see Brazil facing a binary (set of) macro outcomes, meaning that either the credibility of the constitutional spending cap will be maintained, leading to a (relief) rally in local bonds, or there will be a possible breach of the fiscal regime that could feed further rounds of sell-offs in local yields. We continue to see the credibility of the spending cap as the main driver for the economy and assets after the pandemic.

Economic activity: Retail activity has confirmed the market's expectations of another gain in August. Following the upward trend anticipated by our proprietary coincident index for retail sales (IGet), the headline index pointed to growth of 3.4% MoM s.a. (+6.1% YoY), a better result than the market consensus projection (3.0%) and an all-time high. The headline broad retail sales number (including auto and construction) rose 4.6% MoM s.a. (2.9% YoY), reaching the highest level since November 2014. This positive result for August implies the broad headline number has fully recovered from the drop registered between March and April, and relative to the pre-crisis level, the core and the broad retail index are above February's reading by 8.2% and 2.2%, respectively. With today's results, assuming no growth in the remaining months of the quarter, we calculate that quarterly growth for 3Q20 stands at 17.8% and 24.1% for the core and the broad indexes, respectively.

[1] https://cms.santander.com.br/sites/WPS/documentos/arq-mind-the-fiscal-risk-premium/20-10-09_140012_special+-+mind+the+%28fiscal+risk%29+premium.pdf

Among the categories, 7 of the 10 segments of the broad index posted positive variation. August's positive monthly result was driven to a large extent by segments such as Vehicles (8.8%), Clothing (30.5%) and Building Materials (3.6%). The negative highlight was Books (-24.7%), while Supermarkets and Pharmaceuticals, which showed some resilience in the crisis, registered declines of 2.2% and 1.2%, respectively. In our view, this softening result for Supermarkets could be due to a rise in food prices. Relative to the pre-crisis level, 5 sectors are above pre-pandemic readings, especially Furniture (24.2%) and Building (19.2%), reflecting the more time spent at home by the consumers due to the social isolation measures.

In our view, the gradual reduction of emergency aid may decelerate the upward trend seen up to now, but since the aid will be paid until the end of the year, we expect sequential growth for retail sales in the coming months. One downside risk is a substantial increase in services consumption as social isolation measures are eased, substituting retail sales expenses. On the other hand, Apparel and Vehicles are still 9.4% and 12.9%, respectively, below February's reading, suggesting that there is a gap to be filled, which is a possible upward risk for retail sales.

Fiscal policy: In our October 7 report, *Borrowing Requirements and Debt Management: The Importance of the Fiscal Adjustment*[2], we analyzed the impact of heightened fiscal risks from the standpoint of debt management. Considering the rising fiscal uncertainty, especially on the fate of the constitutional spending cap, the Treasury's cash position is being used much more intensely this year. The risk of creating new mandatory expenses, without curbing others, and not complying with the spending cap rule is affecting Treasury auctions and debt premia, in our view. Therefore, we reiterate the importance of complying with the spending cap rule and advancing fiscal reforms in order to reduce structural risk, maintaining the neutral interest rate at low levels and also attracting foreign investment in Brazil, with a perspective of long-term debt solvency.

Additionally, a release of the Federative Pact (constitutional amendment) report was again postponed, with some controversy generated by the plan to finance a new welfare program. The formal proposal will be only released after municipal elections are held at the end of November. The proposals and ideas studied to finance the program will continue to appear until then, in our view. Finally, on the overturning of several presidential vetoes, the vote is now scheduled for November 4.

Inflation: September's IPCA registered a 0.64% MoM change (3.14% YoY). The result was a considerably above the market's median expectation (0.54% MoM) and also our forecast (0.56% MoM).

The upside surprises were concentrated in free prices (+13 bps). The major surprise was in industrial goods at 0.58% MoM (+7bps of error) – we have been flagging this was an upside risk as some drivers pointed upwards: economy each time more opened, with government's emergency aid still in place, BRL still devalued and some (temporary and supply shortages. Core measures also accelerated (although to still very low levels) on the heels of a stronger industrial goods inflation. Another upside surprise was food-at-home at +2.89% MoM (+3 bps of error), which has been a source of pressure in recent readings. Services were more in line, rising 0.17% MoM (only +2 bps of error). Finally, on administered prices there was a downside surprise of -5 bps, driven by gasoline.

This upside surprise made us revise our IPCA 2020 high-frequency tracking a bit further upward, from 2.8% to 3.0% (versus the official forecast of 2.3%). Looking ahead, however, despite that considerable upside surprise in industrial goods, which is more related to core measures, we believe the drivers behind the acceleration should cool down next year. Moreover, we project that services will continue running low, as the job market is expected to be weak, and food-at-home inflation is forecast to decelerate considerably. We believe the well-anchored inflation expectations should also play an important role in price dynamics in Brazil. Therefore, we continue to anticipate a benign scenario of inflation in the medium term, with core measures running at a low level, and we forecast 2021 headline IPCA at 2.7%.

Next week: On the macro agenda, the IBGE and BCB will release services activity data and the monthly activity index (IBC-Br), capping the batch of activity index releases for August. We project sequential gains of 1.9% MoM s.a. (-11.4% YoY) for services and 1.3% MoM s.a. (-4.7% YoY) for broad activity, respectively. More than 60% of the data relative to the third quarter will be available, so we can track with relatively lesser uncertainty the economic activity outcome after the sharp drop seen last quarter. Based on the available data, our tracking for 3Q20 GDP is running at 8.7% QoQ s.a. (-3.5% YoY).

[2] https://cms.santander.com.br/sites/WPS/documentos/arq-borrowing-requirements-and-debt-management/20-10-09_140544_special+-+borrowing+requirements+and+debt.pdf

MACRO AGENDA

Indicator	Date	Estimate	Prior
IBGE Services Sector Aug/20 (% YoY)	Wed, 14-Oct	-11.4	- 11.9
CNI Industrial Confidence Oct/20 (points)	Wed, 14-Oct	-	61.6
IBC-Br Economic Activity Aug/20 (% MoM)	Thu, 15-Oct	1.3	2.2
IBC-Br Economic Activity Aug/20 (% YoY)	Thu, 15-Oct	-4.7	- 4.9
FGV CPI IPC-S Oct/20	Fri, 16-Oct	-	-
FGV Inflation IGP-10 Oct/20 (% MoM)	Fri, 16-Oct	-	4.34

Sources: Bloomberg and Santander.

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