Santander

ECONOMICS

February 28, 2019

Brazil—Inflation

Lower Inflation Forecast for 2019

Vagner Alves*
vagner.alves@santander.com.br
+55-11-3553-5102

- **We have reviewed our forecast and now expect 2019 CPI to end the year at 3.5% (versus 3.7% previously).**
- **We consider GDP growth of 2.3% and an exchange rate of BRL4.00/USD for YE2019 (with an annual average of BRL3.80/USD). However, we emphasize that the Brazilian economy will continue to have a high idle capacity, implying that the output gap will remain negative until YE2020, according to our estimates.**
- **Core inflation as calculated by Santander has been below the 4.5% target since YE2016, and our models indicate that it should remain within a comfortable range of 3.0-3.5% in 2019.**
- **This scenario of benign inflation below the center of the Central Bank's target (4.25%) reinforces our view that the Selic rate will stay in 6.5% per year until the first quarter of 2020.**
- **We expect regulated prices to decelerate from 6.2% to 4.9%, due to lower gasoline prices. In addition, food at home inflation should remain well behaved due to increased crop production.**
- **On the other side, services inflation will accelerate from 3.3% to 3.7% following improved economic activity and the minimum wage increase.**

Figure1: IPCA – Annual Variation

		2015	2016	2017	2018	2019 (E)
IPCA	Weight	10.7	6.3	2.9	3.75	3.5
Regulated	25.9	18.1	5.5	8.0	6.2	4.9
Gasoline	4.3	20.1	2.5	10.3	7.2	1.1
Electricity	3.8	51.0	-10.7	10.4	8.7	8.7
Free prices	74.1	8.5	6.5	1.3	2.9	3.0
Durable goods	7.7	3.3	1.4	-1.7	1.7	1.0
Semi-durable goods	7.5	5.3	4.1	2.3	0.8	2.2
Services	35.7	8.1	6.5	4.5	3.3	3.7
Core Services	22.3	9.5	6.3	3.7	3.1	3.6
Non-durable goods	23.3	12.3	8.7	-2.7	3.3	3.0
Food at home	15.9	12.9	9.4	-4.9	4.5	3.9

Source: IBGE and Santander.

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.

U.S. investors' inquiries should be directed to Santander Investment at (212) 350-0707.
*Employed by a non-US affiliate of Santander Investment Securities Inc. and is not registered/qualified as a research analyst under FINRA rules.

Introduction

In this report, we detail our outlook for the 2019 CPI (IPCA in Portuguese). We expect an increase of 3.5% (versus 3.7% previously), below the Central Bank's target of 4.25%. We maintain our 2020 forecast of 4.0%. In analyzing the CPI's main categories, we used a bottom-up approach.

We consider GDP growth of 2.3% and an exchange rate of BRL4.00/USD at year end (an annual average of BRL3.80/USD). However, we emphasize that the Brazilian economy will continue to have a high idle capacity, implying that the output gap will remain negative until YE2020, according to our estimates. The output gap is a relevant explanatory variable for core inflation indicators, which react to side effects of various shocks that can affect the economy. As seen in Figure 3, core inflation as calculated by Santander has been below the 4.5% target since YE2016 and our models indicate that it should remain in the comfortable range of 3.0%-3.5% in 2019.

Figure 2: Output Gap (Estimates from 3Q18)

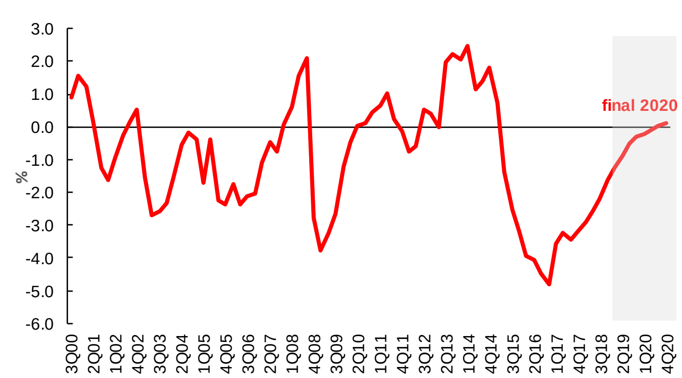
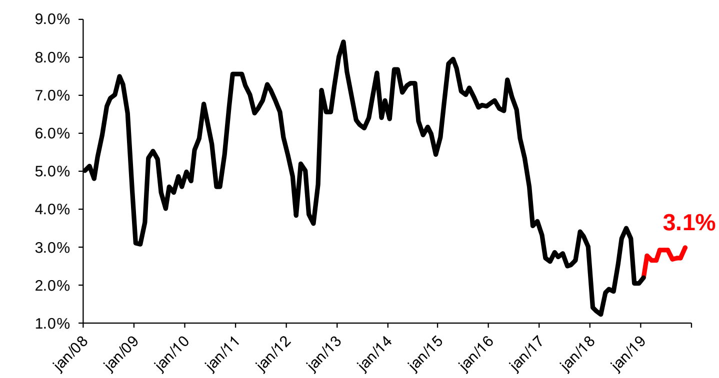


Figure 3: Santander Core Inflation –3M Moving Average (S.A.)



Source for both figures: IBGE, BCB and Santander.

This scenario of benign inflation below the center of the Central Bank's target (4.25%) reinforces our view that the Selic rate will stay at 6.5% per year until 1Q20.

In the following sections, we present our forecasts and main assumptions for the IPCA's main categories in 2019.

Regulated Prices (weight[1] 25.9%)

The subcategories of regulated prices, which mainly includes public transport, regulated services and fuels, have been running above 4.5% since the beginning of 2014 due to supply shocks (lack of rainfall), BRL depreciation and sectoral measures that did not work. For 2019, we expect a slowdown for these subcategories, from 6.2% to 4.9%.

Figure 4: IPCA – Regulated Prices (%)

	2015	2016	2017	2018	2019 (E)
Utilities					
Water and Sewage	14.8	20.1	10.5	4.5	6.3
Telephone	-1.6	-1.2	-5.4	-1.3	-1.2
Electricity	51.0	-10.7	10.4	8.7	8.7
Fuel and transportation					
Bus fares	15.1	9.3	4.0	6.3	6.8
Gasoline	20.1	2.5	10.3	7.2	1.1
Health					
Medicinals	6.9	12.5	4.5	1.6	3.2
Health care plan	12.2	13.6	13.5	11.2	8.1
Regulated Prices	**18.1**	**5.5**	**8.0**	**6.2**	**4.9**

Source: IBGE and Santander.

[1] For all groups we consider the 2019 February weights

Durable goods (weight 7.7%) and Semi-Durable Goods (Weight 7.5%)

Inflation for industrialized goods is correlated with economic activity and FX variations. Within the durable goods group, home appliances show greater sensitivity to FX movements, while automobiles have good adherence to the trend of vehicle sales.

We forecast a 1.0% increase for durable goods inflation, decelerating from 1.7% in 2018, while for semi-durable goods, we forecast inflation acceleration to 2.2%, up from 0.8%. Even with economic activity improving, our models show the output gap remaining negative, limiting the impact of increasing household consumption on inflation and reducing the exchange rate pass-through.

Figure 4: IPCA – Durable Goods (12M Accumulated)

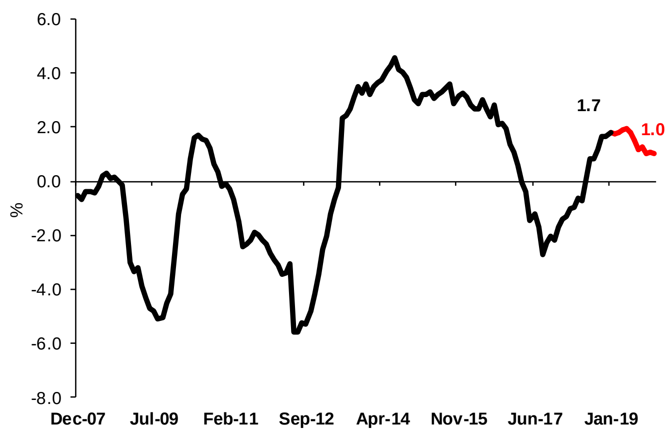
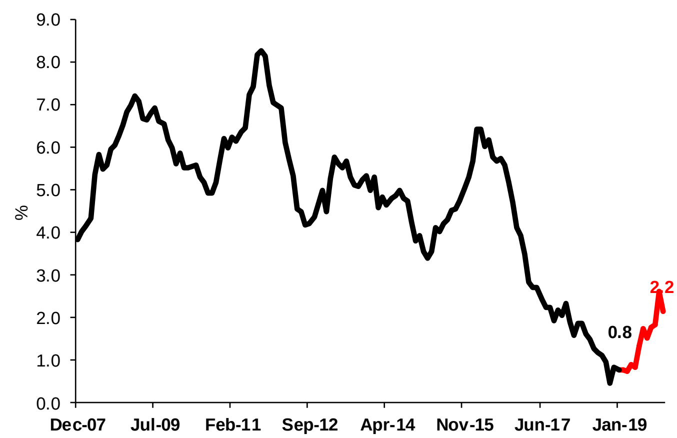


Figure 5: IPCA – Semi-Durable Goods (12M Accumulated)



Sources for both figures: IBGE and Santander.

Services (Weight 35.7%)

We forecast that inflation for services group will accelerate from 3.3% to 3.7% in 2019, with the resumption of growth and a slight real increase in the minimum wage. We divided our category analysis into two subcategories: services related to income and services related to economic activity.

Within services income-related inflation, we expect to have rents and health services accelerating due to a lower average unemployment rate and higher income, while education will decelerate due to lower costs (in 2018) and inertial inflation.

Figure 6: IPCA Education – Annual Variation

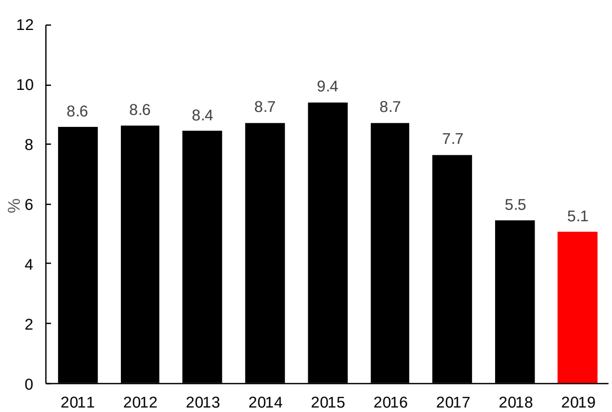
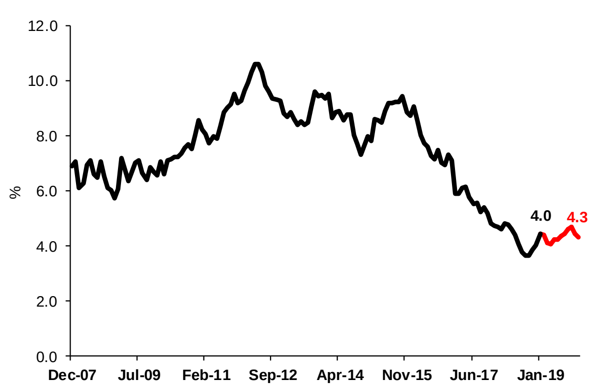


Figure 7: IPCA – Health Services – (12M Accumulated)

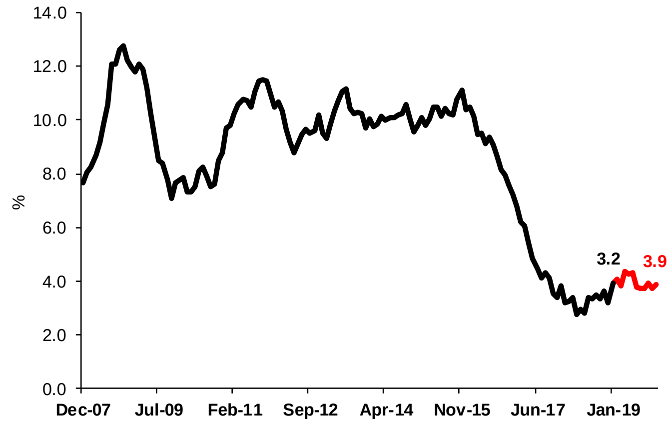


Sources for both figures: IBGE and Santander.

Within services related to the economic activity, the main subcategory is food away from home, which should accelerate from 3.2% to 3.9%, according to our projections, due to higher GDP growth.

Figure 8: IPCA Services – (12M Accumulated)

Figure 9: IPCA Food Away from Home - (12M Accumulated)



Sources for both figures: IBGE and Santander.

Non- Durable Goods (Weight 23.3%)

Non-durable goods' main subcategory, food at home (weight 15.9%) and some sub-items such as ethanol. We forecast 4.0% deflation for biofuels in 2019 after price stability in 2018.

Figure 10: IPCA Non-Durable Goods – (12M Accumulated)

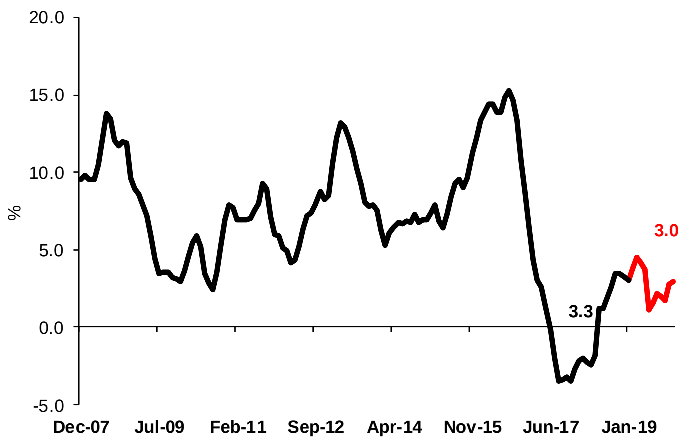
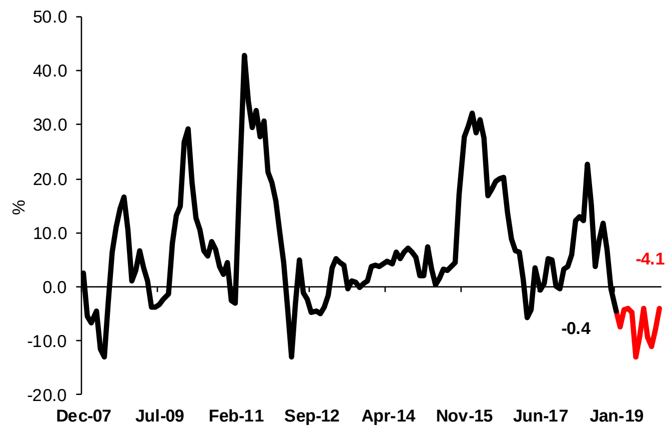
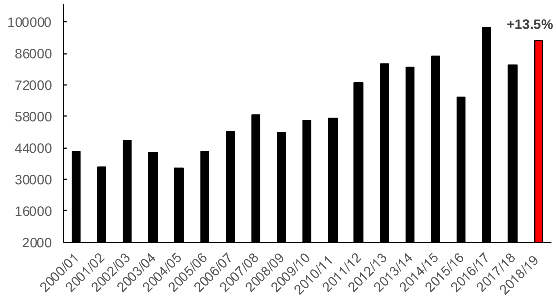


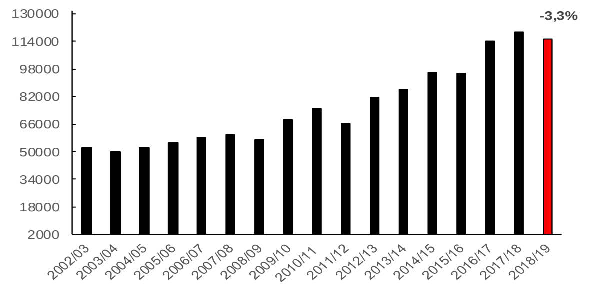
Figure 11: IPCA Ethanol – (12M Accumulated)



Sources for both figures: IBGE and Santander.

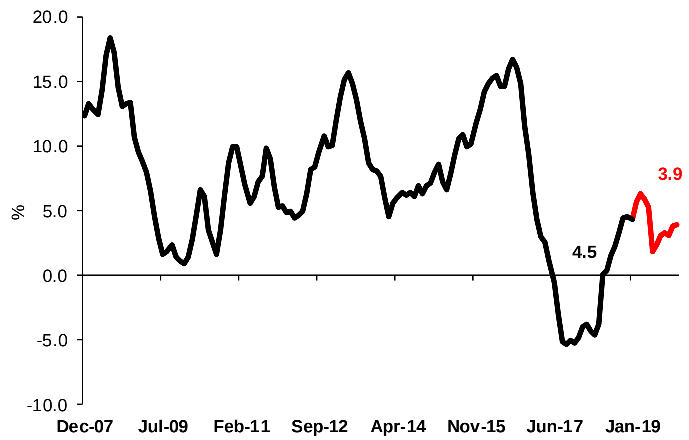
Food at home should decelerate from 4.0% to 3.9% in 2019, according to our projections. Starting with the weather, January and February were characterized by below average rainfall and relatively high temperatures, reflecting El Niño (weak intensity), as confirmed by the United States National Oceanic and Atmospheric Administration (NOAA); for the rest of the year, however, we expect weather normalization, which would be positive for food prices. In addition, we expect a reduction in input costs (animal feed), as strong crop production is expected for this year.

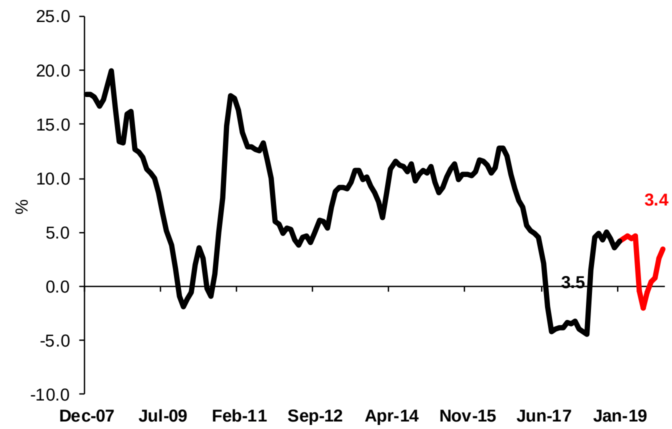




Sources for both figures: CONAB and Santander.

We expect a larger grain harvest will help the protein sector (beef, chicken and milk) present relatively stable inflation compared to 2018, even with increased household consumption, noting that these sectors are also highly sensitive to income improvement in the short term.





Sources for both figures: IBGE and Santander.

Conclusion

We expect the IPCA to increase by 3.5% in 2019. Regulated prices is the main group responsible for the deceleration, while free prices are expected to accelerate from 2.9% to 3.1%, driven by services and semi-durable goods inflation.

This scenario of well-behaved and below the center of the target inflation reinforces our perspective that the Selic rate will stay in 6.5% per year until the first quarter of 2020.

Figure 15: IPCA – Annual Variation

		2015	2016	2017	2018	2019
IPCA	**Weight**	**10.7**	**6.3**	**2.9**	**3.75**	**3.5**
Regulated	**25.9**	**18.1**	**5.5**	**8.0**	**6.2**	**4.9**
Gasoline	4.3	20.1	2.5	10.3	7.2	1.1
Electricity	3.8	51.0	-10.7	10.4	8.7	8.7
Free prices	**74.1**	**8.5**	**6.5**	**1.3**	**2.9**	**3.0**
Durable goods	7.7	3.3	1.4	-1.7	1.7	1.0
Semi-durable goods	7.5	5.3	4.1	2.3	0.8	2.2
Services	35.7	8.1	6.5	4.5	3.3	3.7
Core Services	22.3	9.5	6.3	3.7	3.1	3.6
Non-durable goods	23.3	12.3	8.7	-2.7	3.3	3.0
Food at home	15.9	12.9	9.4	-4.9	4.5	3.9

Source: IBGE and Santander.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Diana Ayala	Economist – Colombia, Peru	diana.ayala@santander.us	212-407-0979
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537

Fixed Income Research

Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
David Franco*	Macro, Rates & FX Strategy – Latin America	david.franco@santanderCIB.co.uk	44-207-756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978

Equity Research

Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Nicolas Schild*	Head, Chile	nschild@santander.cl	5622-336-3361
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Cecilia Jimenez*	Head, Mexico	mcjimenez@santander.com.mx	5255-5269-2228

Electronic Media

Bloomberg	SIEQ <GO>
Reuters	Pages SISEMA through SISEMZ

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Lucas Nobrega* and Rodolfo Margato*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

© 2019 by Santander Investment Securities Inc. All Rights Reserved.

Santander
Corporate & Investment Banking