

Brazil Macro Compass**Low Inflation Paving the Way for Another Rate Cut**

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What's New: Yet Another Low Inflation Release

February CPI inflation came in at 0.32% m/m, slightly above our estimate (0.29%) but still comfortably low. It was the lowest February monthly inflation since 2000. Twelve-month inflation, at 2.84%, is still comfortably below the target lower bound, and core inflation continued to decelerate (from 2.96% in January to 2.89%, according to the measure that excludes foodstuff and regulated prices). **Year to date, measured inflation is 39 bps lower than what the Central Bank (BCB) forecasted in its December Quarterly Inflation Report.** That and a more favorable outlook for the remainder of the year (BCB official forecast for year-end 12-month inflation is 4.1%; we project 3.5%) leads us to believe that BCB can deliver another rate cut in March 21, bringing the Selic rate to 6.5%. That should come with a revision in its forecasts, in our view, to be detailed in this year's first *Quarterly Inflation Report* (to be published on March 29).

Industrial production fell 2.4% m/m in January, in-line with our expectations. This negative reading offsets an extraordinary December performance (revised this month from +2.8% m/m to +3.1% m/m), smoothing out a positive trajectory in a wider period: compared with January 2017, the index is 5.7% higher. Our estimated diffusion index shows 65% of around 100 manufacturing segments expanding production, compared with only 30% a year ago. We expect industry to grow 4.7% in 2018.

U.S. steel and aluminum tariffs: Brazil is the second largest exporter of steel to the United States and, so far, the producer most affected by the new tariffs, since Canada was exempted in last Thursday's announcement. Despite the immediate hit to a struggling industry, the first-order macro impact to Brazil should be almost negligible, even assuming a very steep demand curve for the commodity. The average value of yearly steel exports to the U.S. between 2013 and 2017 was little more than USD 3 billion (almost exactly the value exported in 2017, from USD 2.2 billion in 2016), compared with yearly average exports (in the same period) of USD 212 billion. Brazil aluminum exports to the U.S. in 2016 and 2017 were only USD 144 million and USD 119 million, respectively.

Upcoming Data: A Light Schedule Ahead

Next week's only relevant releases are two pieces of economic activity data from January. We expect core retail sales to have grown 0.7% in the month, while the volume of services should fall 0.3% in the same period, in our view. Those results, along with the industrial production figures mentioned in the previous section, would point to a 0.5% monthly contraction in BCB's monthly GDP proxy (IBC-Br), to be released in the following week.

In-depth Research: Food Prices Dynamics

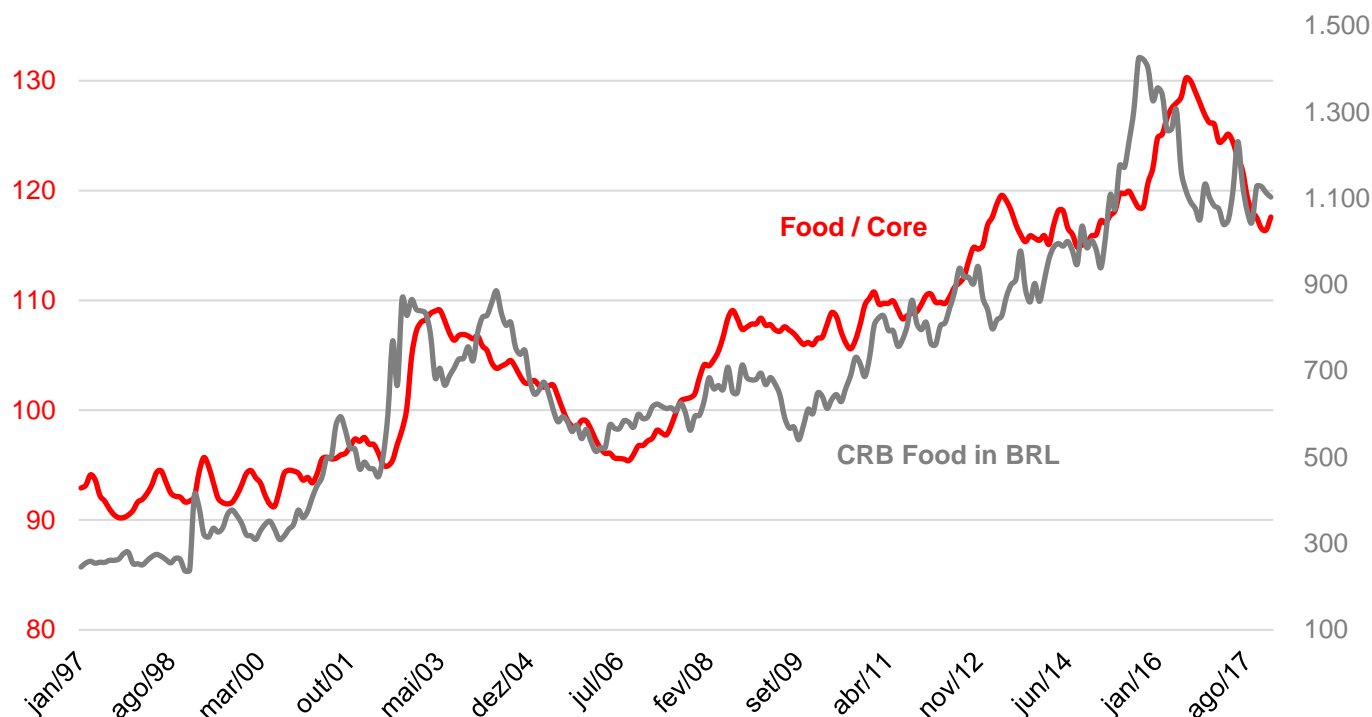
In our March 7, 2018 report, *Food (Inflation) for Thought: Relative Prices*, we offer an analysis of food prices relative to "core" prices in Brazil's main consumer price index. We show that relative food prices are highly correlated with the CRB Food index in BRL (see the Chart of the Week below) and that currently there is no significant divergence between the two measures, suggesting that there is no repressed adjustment to be unloaded. Food inflation is highly seasonal, concentrated in the first and fourth quarters of the year, in Brazil, and low readings so far this year (probably only 0.2% between January and March) should, in our view, continue to drag down inflation expectations.



Chart of the Week: CRB Food Strongly Associated with Relative Food Prices

Over the last 20 years, food prices in Brazil relative to CPI core components (excluding food and regulated prices from the consumption basket) have been following closely international food prices converted to BRL, as measured by the CRB Food index. (See the previous section.)

Brazil—Food/Core Relative Prices (Jan '96 = 100) vs. CRB Food in BRL (Jan '67 = 100)



Sources: IBGE, Bloomberg, Santander.

Political Agenda: A New Presidential Poll

A new presidential election poll (by MDA Pesquisa) was released this week, showing no major changes relative to the latest Datafolha poll (from January 31). Main points, in our view, all suggest a very open race so far:

- In first round scenarios that do not include former president Lula (who has 33% of total votes in the only simulation he was included), the sum of the shares of undecided voters and voters who would vote blank or null jumps from 25% to something between 39% and 42%, which means that about half of the electors that would like to vote for Lula still did not decide for another candidate.
- Jair Bolsonaro leads in all scenarios that don't include Lula, with a minimum of 20% of total votes. Marina Silva is the runner-up in all such scenarios, polling between 13% and 14%. PSDB's Geraldo Alckmin comes third when included, with around 9%.
- In the only scenario he was included, President Michel Temer has 1.3% vote intention, less than former president Fernando Collor (2.1%).
- Run-off simulations without Lula have a very high share of undecided/blank or null votes, none less than 36%. Bolsonaro has a tight lead (less than three percentage points) over both Alckmin and Marina. Marina would beat Alckmin by less than two percentage points.



- In terms of rejection rates (share of people who would not vote to the candidate under any circumstance), Michel Temer has 88%, whereas Alckmin and Bolsonaro have very similar rates (50.7% and 50.4%, respectively). Marina is rejected by 54% of the polled.

Until April 7, the window for seating representatives to change parties freely remains open, so the negotiations and announcements should continue to dominate the legislative agenda, in our view.

Number of the Week

1/3

Almost one-third of the income of Brazil's judges and public prosecutors is exempt from income tax, mainly because of housing stipends and other bonuses (data from the Revenue Service). A Supreme Court vote, scheduled for March 22, should decide on the legality of housing stipends for federal judges.

Quote of the Week

[Protectionism] is something negative to everyone involved, including to the American industry and consumer, since inputs get more expensive.

Finance Minister Henrique Meirelles, quoted by *Valor* newspaper online.

What We've Been Reading

- *Fear Not, Says Brazilian Candidate Aiming to Tax the Rich*, by Bruce Douglas (Bloomberg). An interview with presidential precandidate Ciro Gomes.
- "Emerging Markets Under Pressure as Debt Mounts," by Jonathan Wheatley (*Financial Times*). Most emerging countries increased leverage significantly, especially in local currency, after the global financial crisis. Monetary policy in the developed world turning hawkish might spoil the party.
- *Brazil's Federal Intervention in Rio's Drug Wars Has an Authoritarian Feel—and Could Backfire*, by Benjamin Lessing (Monkey Cage). A University of Chicago professor compares the intervention in Rio with the battle declared by Felipe Calderón on Mexican cartels in 2006, and argues that such demonstrations of "abnormal politics" may end up eroding democracy.
- *The Convergence in Emerging Market Inflation*, by Kevin Daly and Loughlan O'Doherty (VoxEU). According to the authors, increased monetary policy credibility and improvements in emerging countries' balance sheets are behind the convergence in inflation rates since the 1990s.
- *Emprego e Crescimento: a Agenda da Produtividade* (World Bank). A comprehensive assessment of Brazil's (lack of) economic productivity. So far only available in Portuguese.
- "36 Hours in São Paulo," by Seth Kugel (*The New York Times*). Nice and up-to-date tips for the accidental tourist in Brazil's main financial center.

Recent Publications (Available on Our Website)

- *Food (Inflation) for Thought: Relative Prices* (March 7, 2018)
- *One-Off Is Not Enough* (February 20, 2018)
- *Even Better Than the Real Thing* (February 15, 2018)
- *Social Security Reform: Same Proposal. Different Probability?* (February 8, 2018)
- *Why Has the BRL Weakened in 2017?* (January 8, 2018)



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