Santander

ECONOMICS — March 23, 2018

Brazil Macro Compass

A Surprisingly Dovish Central Bank

Luciano Sobral*
lusobral@santander.com.br
+5511 3553 3753

What's New: A Surprisingly Dovish Central Bank

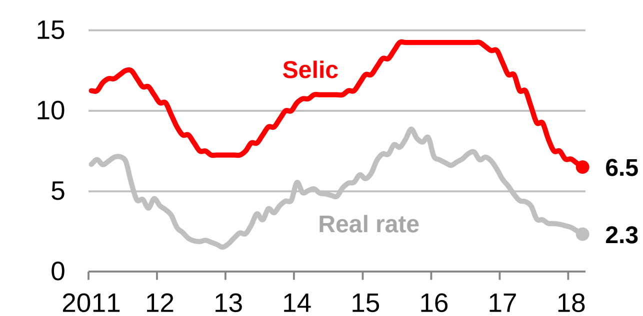
As widely expected, Brazil's Monetary Policy Committee (Copom) cut the overnight policy rate (Selic) to 6.5% (from 6.75%) this week. **However, markets were surprised by a more dovish stance, which lead us to revise our year-end Selic rate estimate to 6.25% (from 6.5%).** The communiqué clearly stated that "regarding the next meeting [*on May 16*], at this time the Copom views an additional moderate monetary easing as appropriate." **Copom also updated its 2018 and 2019 central model inflation forecasts to 3.8% and 4.1%, respectively (from 4.2% for both years)**.

In our view, this latest communiqué marks an improvement in communication, as it clarifies that: (i) the Central Bank (BCB) is pursuing the midpoint of the inflation target range in 2019 (4.25%); (ii) the Committee is not indifferent to 2019 inflation right at the target and a 15-bp lower inflation (if that were the case, it could have simply said that 2019 inflation was "around the target" without providing a point estimate, as it has done in the past); and (iii) **Copom's current key concern is that it could undershoot relevant inflation targets (2018 and 2019)**, thereby delaying the economic recovery (as suggested in the statement, "the Committee judges that this additional stimulus mitigates the risk of delayed convergence of inflation toward the targets").

We believe that the Central Bank will keep the door open to additional monetary easing from June onward, should core inflation keep surprising to the downside (a risk made explicit in the communiqué), although our base-case is a flat rate (at 6.25%) until 2H19. **The key variable to observe until then is, in our view, 2019 inflation expectations**, as by June their weight in Copom's reaction function should become dominant. Our year-end 2019 CPI inflation forecast of 4.0% is slightly below BCB's estimate, but we do not believe this difference would be enough to justify an extra rate cut to 6.0%. In any case, we believe that risks remain biased toward a terminal rate below 6.25%, as 12-month core inflation is (according to our models) likely to continue falling, thus potentially leading to downward consensus revisions for 2019 inflation.

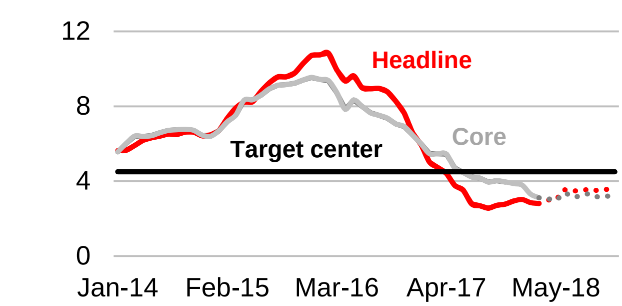
We maintain our year-end 2019 Selic forecast at 8.50%. Given our GDP growth estimates (3.2% for both 2018 and 2019), we believe that by 2H19 spare capacity in the economy will be almost completely fulfilled and that strong domestic demand will require a real interest rate close to the neutral level (around 4.0%, according to our estimates) to keep inflation expectations anchored to their respective targets. For more details, see our reports, *In Search of Lost Growth: What Is the Extent of Spare Capacity in Brazil's Economy?* (October 20, 2017) and *Monetary Policy and the Last Crusade* (August 30, 2017).

Selic and 12-Month Real Ex Ante Rates (%)



Sources: Brazil Central Bank, Anbima, Santander.

12-Month CPI Inflation (%)



Sources: IBGE, Santander estimates (dotted line).

March IPCA-15, a preview of the official CPI measure released this week, came in slightly above our expectations, at 0.10% m/m. However, 12-month inflation kept decelerating (to 2.8% from 2.86% in February), and core inflation in the same period stayed around 3.0%. We continue to expect 12-month inflation to end this year at 3.5%.

Upcoming Data: More on Monetary Policy

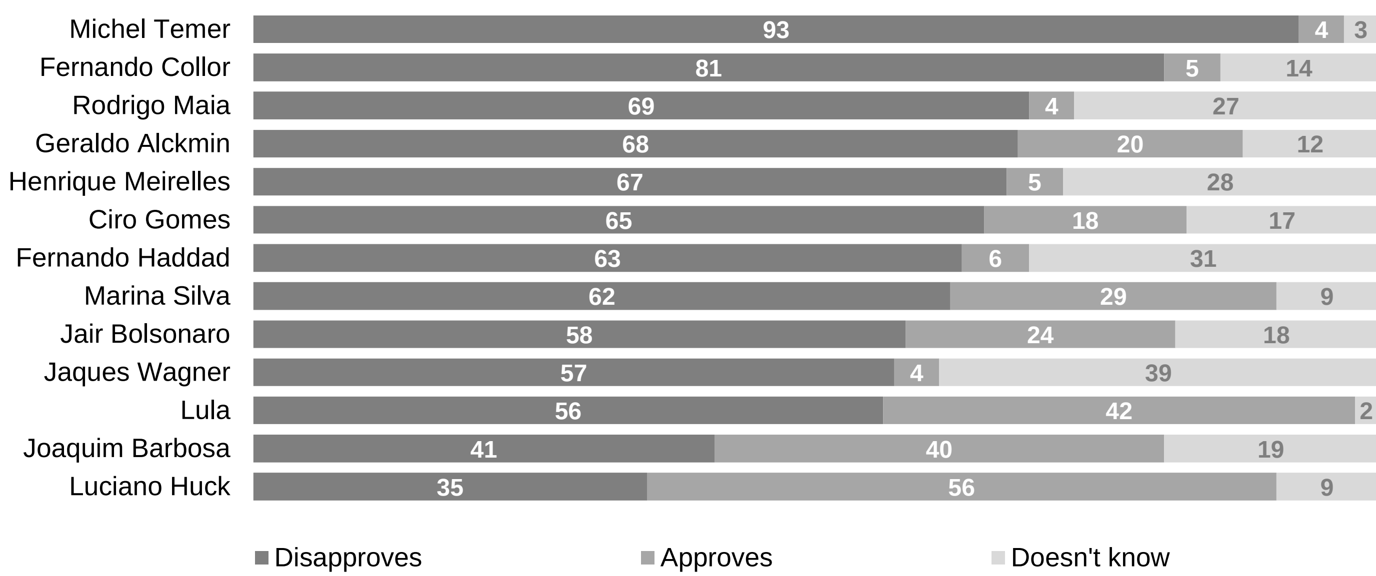
On Thursday, BCB releases its Quarterly Inflation Report, which should provide more details on what is behind the updated forecasts released with this week's rate decision (see above). Governor Goldfajn will give a collective interview following the report, which will become a regular feature of the report's release. The minutes of the latest Copom meeting will be released next Tuesday.

On the economic activity front, **February's unemployment rate will be released next Thursday. We expect the seasonally adjusted unemployment rate to fall to 12.3% (from 12.4%)**, following the gradual recovery trend started one year ago. Also next week (no day defined) the Ministry of Labor publishes its monthly formal job creation report. We expect a net creation (after the seasonal adjustment) of 35,000 jobs in February.

Chart of the Week: Potential Presidential Candidates Approval Ratings

Estadão and Ipsos released this week their Political Barometer survey, which gauges on a monthly basis the approval ratings of several political personalities. All experienced politicians have approval ratings below 50% (this does not necessarily convert into vote intentions, though).

Do You Approve or Disapprove of the Way This Person Has Been Acting In the Country? (% of respondents)



Source: Ipsos Public Affairs, 1,200 interviews made between February 1 and 16, 2018.

Political Agenda

The "party window" for representatives to freely change parties will probably continue to delay the legislative agenda until April 7. However, this week the Lower House managed to approve an urgency request regarding the bill that removes payroll tax breaks conceded by the previous government, which may go to the floor for a vote soon (but probably not next week, since Brasília is likely to be empty ahead of the Easter holidays). The bill sent by the government, already watered down by the rapporteur, could become ineffective in terms of increasing tax revenue if more sectors are granted an extension of the current tax breaks.

Another event to watch for is the rule by a Federal Court of Appeals on a motion that followed former President Lula's conviction on January 24. Last Thursday the Supreme Court postponed (to April 4) a final ruling on a *habeas corpus* requested by Lula's defense, also granting him an injunction that prevents the execution of an arrest order until that ruling. It will be up to the Supreme Court, under enormous pressure, to decide on whether a convicted former president should be sent to jail.

Number of the Week

12%

Brazilian authorities estimate that 12% of the population of Boa Vista, the capital city of Brazil's northernmost state, is composed of Venezuelan refugees. 40,000 Venezuelans are straining the supply of public services to an isolated and impoverished region.

Quote of the Week

We are at unprecedented levels of tax relief. Tax breaks used to be around 1.5% of GDP. Now we are at 4.5% of GDP. This is money that could go to healthcare, education, public security, and now it is being given to the corporate world. Is it worth it?

— **Persio Arida**, coordinator of Geraldo Alckmin's economic plan, quoted by *Estadão* (March 18, 2018).

What We've Been Reading

- "How the markets now run Brazil", by Rob Dwyer (*Euromoney*). The author dissects the common view that whoever gets elected Brazil's president will have to continue with fiscal consolidation, pushed by financial markets.
- "Brazil 2018: The "Chuchu Popsicle" Makes His Case", by Brian Winter (*Americas Quarterly*). A profile of Geraldo Alckmin and a good analysis of his presidential bid.
- *Booms, Crises, and Recoveries: A New Paradigm of the Business Cycle and its Policy Implications*, by Valerie Cerra and Sweta Chaman Saxena (IMF Working Paper No. 17/250). The authors claim that all types of recessions lead to permanent output losses, which should lead governments to increase efforts in crisis prevention.
- "People Are Ready to Buy Some Guns in the World's Murder Capital", by David Biller (*Bloomberg*). An upsurge in violent crime and heated rhetoric are leading to increased support to relax gun ownership laws in Brazil.
- "Brazil's Jaw-Dropping Corruption Scandal Comes to Netflix", by Larry Rohter (*The New York Times*). Netflix launches today "The Mechanism", an eight-episode series on the Operation Car Wash and the string of high profile corruption scandals it triggered.

Recent Publications (Available on Our Website)

- *Food (Inflation) for Thought (2): Forecasts* (March 9, 2018)
- *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)

CONTACTS / IMPORTANT DISCLOSURES

Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.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	diana.ayala@santander.us	212-350-0979
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.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 Miguel 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
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
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

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: Luciano Sobral*.

*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.

Santander