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Brazil Macro Compass

A Nerve-Wrecking Week

Ana Paula Vescovi* and
Brazil Macroeconomics Team
anavescovi@santander.com.br
+5511 3553 8567

- **Rates markets now reflect a high probability of new rate cuts, following a Central Bank statement issued last Tuesday. High global volatility is leading to an even steeper yield curve.**
- **Brazilian GDP recorded 1.1% growth in 2019 despite external headwinds weighing on the performance of net exports and a negative contribution from government consumption due to fiscal constraints. As uncertainties abroad are unlikely to vanish soon and fiscal reforms are not looming, it will be up to the domestic private sector to keep pushing the economy gradually up.**
- **Next Wednesday (March 11), the Brazilian official bureau of statistics (IBGE) is set to release February inflation, which we expect to confirm the upbeat backdrop. We expect the IPCA to have registered a 0.15% MoM change, implying a 3.90% reading in YoY terms—below the Central Bank's target for this year (4.00%).**
- **After many days of stalemate and intense negotiations, lawmakers did not rule out presidential vetoes on a proposal that would give lawmakers even more discretion over 2020's public budget. Hence, a significant short-term political risk should fall from the radar, in our view. Nevertheless, we believe that this turbulence could have ripple effects in the political environment. We believe that the economic reform agenda is unlikely to be interrupted due to these second-order effects, though we do see growing risks of reforms running at a slower pace and with stronger dilution of the original proposals.**

Brazil's local markets had a volatile week, following global gyrations related to the COVID-19 story. The most significant domestic event, in our view, was Tuesday's BCB statement, following the intermeeting rate cut by the Federal Reserve. That consolidated, in the short end of the DI curve, expectations of more rate cuts in the next two Copom meetings: Jul'20 futures now price in a Selic rate ~50 bps lower than the current level. The short end once again significantly outperformed longer tenors, with Jan'21s narrowing 22 bps and Jan'27s widening 5 bps. At current prices, we believe there is no value left in tenors up to Jan'21, but the sell-off of the last two sessions in Jan'22s and beyond is making receiving the Jan'22-Jan'23 segment attractive once again. The main caveat is that intraday correlation between rates and FX skyrocketed in that period, suggesting that even such short rates are trading as risky assets—not exactly a surprise for an emerging market, but a major change from the most recent price action. We keep a neutral stance in the slope of the curve, despite the attractive valuation; we hold our view that flatteners are unlikely to perform well until there is more clarity on the terminal level of the policy rate.

Monetary policy: Facing the FOMC's unexpected and surprising rate cut, as well as overall deterioration in global markets, on March 3 the BCB stated that: "*…in light of the recent events, the economic impact of the global slowdown on the Brazilian economy tends to dominate an eventual deterioration of financial asset prices…*". In our view, the change in the global background (with the COVID-19 shock possibly having contractionary/deflationary effects on the Brazilian economy) and the BCB's statements point to further rate cuts at the next Copom meeting (March 18). We believe that our year-end Selic rate forecast of 4.25% pa carries a downward bias, with Copom's reaction likely still conditioned to the market's behavior for the next couple of weeks. In our view, asset prices' accelerating deterioration since the release of the statement is an important factor to take into account by the monetary authority (for the first time this year, we have seen rising breakeven inflation, and a high correlation between DI futures and the FX rate).

Brazilian GDP 2019: The IBGE released 4Q19 GDP data last Wednesday that confirmed the frustration evident in economic activity coincident indicators in the period. The 4Q19's 0.5% QoQ growth (1.7% YoY) was relatively in line with our estimate of 0.4% QoQ, implying a 1.1% GDP increase in 2019. In our view, the data confirm that the impact of

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FGTS (private workers' mandatory savings fund) stimuli was less than expected. We believe this result had to do with two key factors: (i) some of the expected increase resulting from this temporary incentive was anticipated in 3Q19; and (ii) workers withdrew only about 75% of available resources, whereas we expected workers to withdraw almost the entire existing amount. Despite this frustration, we believe that the composition of Brazilian growth in 2019 was relatively benign, with the private sector having led the process. The domestic absorption grew 1.5% last year, thus indicating that the cyclical recovery followed a sustained path. Among the sectors, we highlight the mining segment's recovery, driven by record oil production.

From the supply standpoint, agriculture grew 1.2% in 2019 (contracting 0.4% QoQ in the last quarter), in line with our estimate. The weight of the sector in 4Q19 GDP was only 2.8%, as the distribution of agricultural crops is concentrated in previous quarters. The drop in sugar cane production (the sector's main crop in 4Q19, according to the IBGE harvest profile) partially justifies the weak result in the period. Incidentally, were it not for livestock activity, which has benefited from the increased exports due to the shock in protein supply resulting from the African swine fever in China, the outcome would have been even weaker.

As for the industrial sector—which expanded 0.4% in 2019 (0.2% q/q in the 4Q19, while we estimated a 0.1% q/q change)—the breakdown of its performance surprised once again. The main positive surprise came from the record oil production that drove the expansion of mining activity, which was more than enough to compensate for the weak performance of the mineral extraction. On the other hand, the performance of the civil construction segment was disappointing, as it registered a 2.5% q/q drop in 4Q19, which contrasted with the expansion seen in the two previous quarters. Despite the frustration with the outcome in the last quarter, the building sector—which suffered the most during the recession—grew 1.5% in 2019, thus putting an end in a five-year streak of contraction. In our view, this sector is extremely important to economic growth this year. The recovery of this sector—extremely sensitive to monetary policy—usually fosters the generation of jobs and stirs private consumption. That's why its 4Q19 figures generated some concern regarding the speed of the Brazilian economic recovery in the following quarters. The manufacturing factories, the main component of the industrial sector, grew 0.1% in 2019 and 0.2% q/q in the 4Q19, thus confirming general expectations generated by coincident indicators. In addition, the GDP for electricity, gas, water, sewage and urban cleaning (Utilities) also showed a positive result, however, less than expected.

Finally, the service sector, which accounts for more than 60% of Brazil's GDP, remained the main driver of domestic economic growth, increasing 1.2% in 2019 (0.6% QoQ in 4Q19, in line with our forecast). However, the "Retail" and "Other Services" categories, which are the most sensitive to income, grew below expectations, reinforcing the perception of a weaker impact from the FGTS.

Overall, we believe that the composition of Brazilian growth in 2019 was relatively benign. From the demand point-of-view, household consumption and investments grew 1.8% and 2.3%, respectively, in 2019. In addition, abiding by current fiscal constraints, government consumption decreased 0.4% last year. That is, the growth observed last year was based on the private sector, which helped domestic absorption grow 1.5% in 2019. On the other hand, on the external front, last year was marked by a slowdown in global growth, trade wars and a series of crises in South American countries (an important destination for Brazilian exports), especially in 4Q19. Hence, net exports provided a considerably negative contribution to GDP in both 4Q19 (-0.8%) as well as in 2019 (-0.5%).

Regarding the outlook for 2020, we expect GDP growth to slow down in 1Q20, once the impact of the temporary income increase stemming from the release of FGTS resources has ended. Moreover, we consider that effects of the one-off slowdown in global growth, resulting from a halt in the supply chain due to the coronavirus outbreak, could hurt Brazil's economic activity. However, the extent of the negative impact depends upon the intensity and duration of the outbreak. As this remains uncertain, we believe this risk factor requires careful monitoring. However, despite the recent increase in uncertainty regarding global and local economic growth, we continue to expect faster growth in the Brazilian economy this year compared with last year. We currently forecast the GDP to expand 2% in 2020, but owing to uncertainties mentioned before, we attribute a downward bias to this projection.

Inflation: Next Wednesday (March 11), the IBGE is scheduled to release February IPCA. We estimate the officially targeted index to have recorded a 0.15% MoM change, implying a 3.90% YoY increase. Similarly to recent inflation results, the food-at-home group has been sanguine, with lower prices for animal protein, and food and vegetables items (we forecast the former to have recorded a -4.06% MoM change and the latter to have printed a 2.89% MoM increase). In addition, recent rainfall has not hit the price of vegetables and tubers, though they have improved the level of water reservoirs, thus opening room for electrical companies to continue charging fees under the so called green-flag provision (during dry periods, companies are allowed to charge additional fees to provide electricity to consumers—the so-called yellow and red flags). We also expect fuel prices to have played a deflationary role owing to the downward adjustment seen last month in gas and diesel costs. As a result, we estimate that the administered price group, which consist of electricity fees and fuel costs, among others, to have recorded a 0.45% MoM change in February.

Looking at core inflation measures, which are closely monitored by the monetary authority, we expect them to continue pointing toward an anchored environment. We calculate the IPCA-EX3—the most sensitive core inflation gauge to the economic cycle—to have increased 0.12% MoM (2.79% YoY), a level far below the target set for this year (4.00%).

The negative risk factor for this sanguine inflation environment remains to be the BRL weakening and how much of this will feed through the economy (in technical jargon, the FX pass-through coefficient). According to our calculations, the FX pass-through coefficient is currently ~2.7%; i.e., if the BRL weakens 10%, we would expect to see the inflation rate (in YoY terms) rise 27 bps over a 12-month period. Our forecast already contemplates BRL weakening and its possible impacts on price changes in the coming months. Nonetheless, we continue to estimate a favorable backdrop for inflation in 2020—we project a 3.1% YoY change for the IPCA this year—as the high level of spare capacity in the economy and anchored inflationary expectations should offset the negative influence of the FX rate depreciation, in our view.

Fiscal policy and the political environment: After many days of stalemate and intense negotiations, the current administration and Congress reached an agreement on new rules for the execution of public budget in 2020. This week legislators deliberated presidential vetoes on items of a bill (Budget Guidelines Law) that would have given legislators even more discretion over the 2020 budget. The main vetoed provisions were: (i) the power of congressional representatives to define which amendments would be carried out as a priority; (ii) the 90-day deadline set to the executive branch to provide the money to ensure that amendments presented by the Federal Budget Rapporteur to be carried out; (iii) punitive measures that would have come into effect in the event of the government not transferring funds related to parliamentary amendments; and (iv) a proportional freeze of discretionary spending among the ministries. In addition, the federal administration submitted three bills (PLNs, acronym in Portuguese) with new guidelines for the execution of public budget and necessary adjustments as a result of the deal with Congress to uphold the presidential vetoes; these proposals still need to be voted upon by the Joint Budget Committee next Tuesday (March 10).

The large amount of resources under the control of the Budget Rapporteur (around BRL30 billion)—as stated in the Budget Guidelines Law approved by the Lower House and Senate at the end of last year—spurred much concern among members of the administration's economic team (which feared, in particular, the capacity of budget management and execution throughout 2020) and even the congressional environment (especially the Senate). In our February 28, *Risk Aversion Goes Viral* report, we noted that the strong showing of the central government's primary result in January—nearly BRL45 billion, according to data published by The National Treasury Secretariat last week—largely reflected a slow pace of primary spending execution due to doubts and impediments stemming from the budget imbroglio. After the (expected, in our view) approval next week of those three bills submitted by the current administration, which will return to the executive branch discretion over BRL15 billion out of the BRL30 billion Congress proposed to control, showing, in our view, that a significant short-term political risk could fall from the radar.

However, we believe that this turbulent period could have ripple effects, as it increased the degree of uncertainty (mistrust) in the political environment. Add to that backdrop a mix of dissatisfactions with the current pace of the economic recovery, the hard talks between important members of the executive and legislative branches and street protests scheduled to happen in mid-March and one won't find any sign of respite in recent tensions. We do not expect the economic reform agenda to be interrupted due to these second-order effects, in view of the government and congressional leaders' commitment to the fiscal adjustment and to measures aimed at increasing domestic productivity. Nonetheless, we believe there are growing risks that reforms (e.g., the fiscal emergency package, the pact for a new federation arrangement, tax reform) will be approved at a slower pace and diluted strongly vis-a-vis the original proposals.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: They Have Not Got It (Yet)* (February 20, 2020)
- *Macroeconomic Scenario: Still on Track, but More Gradually* (February 14, 2020)
- *FX Compass – BRL: We Hope They'd Got It* (January 23, 2020)
- *Brazil Macro Propositions for 2020* (January 13, 2020)
- *Macroeconomic Scenario: A Better Outlook* (December 13, 2019)

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
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	598-1747-6805
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Luciano Sobral*	Senior Economist/Strategist – Brazil	lusobral@santander.com.br	5511-3012-6209
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Equity Research			
Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Daniel Gewehr*	Head, Brazil	dhgewehr@santander.com.br	5511-3012-5787
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