Santander

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Brazil Macro Compass

Copom: Under (FX) Pressure Before the Elections

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Upcoming Data: Rate Decision, IPCA-15, IBC-Br

Brazil's Monetary Policy Committee (Copom) meets next Wednesday for its last rate decision before the upcoming October presidential election (the next meeting after that is scheduled for October 31, the week after the second-round voting). Pressure to hike rate hikes has been mounting, mostly because of the recent BRL weakening trend that may end up contaminating current and expected inflation (see our "Chart of the Week" on page 2 of this report). However, because the output gap remains quite wide (the most recent report from the Senate's Independent Fiscal Institution estimates that real GDP is running 6.4 pp below potential), the exchange rate pass-through seems to be more contained than the models would have suggested, and core inflation measures remain subdued, at around 3% y/y. Probably for those reasons, we believe that 2019 inflation expectations (in the Focus survey), the variable that currently has the greatest weight in Copom's reaction function, remain well-anchored, at 4.11% y/y.

Taking all those factors into account, we believe Copom will stay on hold, keeping the Selic rate at 6.5%. We believe that the slow economic recovery will allow for an expansionary monetary policy until 2H19, although financial market dislocations following the elections (if the president-elect is perceived as non-reformist) may lead BCB to deliver the rate hikes already implied in the short-end of the BRL yield curve.

Selected Financial and Economic Indicators, Behavior Between Copom Meetings

Market prices	**01-Aug**	**14-Sep**	**Change**
BRL/USD rate	3.75	4.21	12.3%
5-year CDS	217	284	67 bps
1-year rate	7.40%	8.25%	85 bps
1-year breakeven inflation	3.33%	4.08%	75 bps
5-year rate	10.59%	12.07%	148 bps
Crude oil WTI (USD)	68	69	1.3%
Crude oil WTI (BRL)	254	289	13.8%
CRB Food (USD)	337	323	-4.2%
CRB Food (BRL)	1,264	1,360	7.6%
Market expectations*	**03-Aug**	**06-Sep**	**Change**
2018 CPI inflation (12m, year-end)	4.11%	4.05%	-6 bps
2019 CPI inflation (12m, year-end)	4.10%	4.11%	1 bps
12-month CPI inflation, year ahead	3.67%	3.89%	22 bps
2018 GDP growth	1.50%	1.40%	-10 bps
2019 GDP growth	2.50%	2.50%	0 bps

* Median of expectations in the Focus weekly survey. Sources: Brazil Central Bank, Bloomberg, Anbima, Santander.

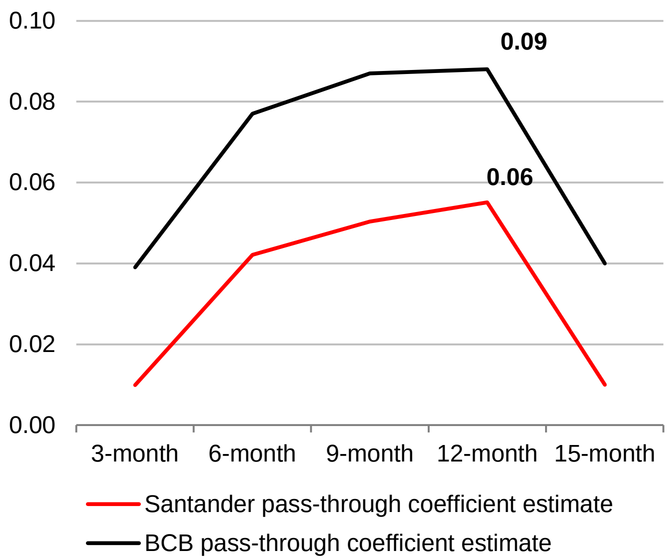
September's IPCA-15 will be released on September 21. We expect monthly inflation at 0.19%, which would be mostly explained by rising prices for fuel, air travel and apparel. Nonetheless, we expect core measures to continue pointing toward yearly headline inflation below 4.0% by year end (we expect 3.9%).

We forecast July's IBC-Br (BCB's monthly GDP proxy) at 0.4% m/m (2.2% y/y), signaling a slow start to 3Q18 (we recently revised downward our 2018 GDP growth estimate; see "In-Depth Research" on page 3).

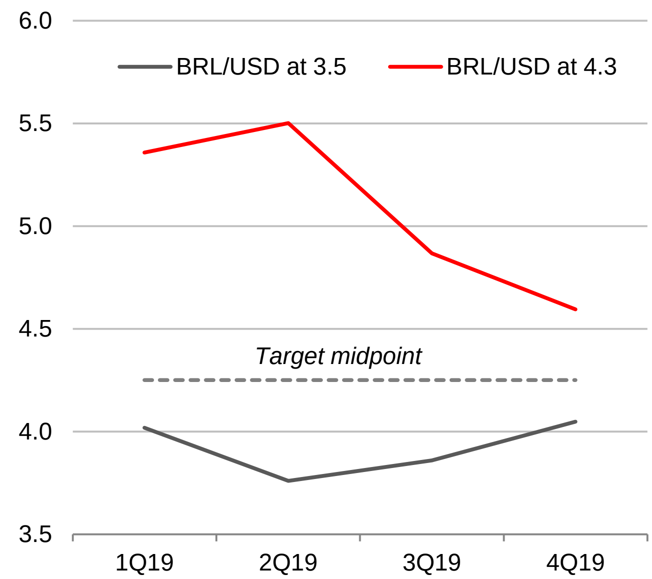
Chart of the Week: Exchange Rate Pass-Through Estimates

Our "Chart of the Week" shows our most recent estimates for the exchange rate pass-through coefficient, presented in the report *Rely on Fundamentals and Carry On* (June 8, 2018). According to our main model, a sustained 10% BRL depreciation adds 60 bps to headline CPI inflation in the following 12 months (i.e., a 0.06 pass-through coefficient), with the estimate sharply decreasing thereafter. A broader model presented by the Central Bank in its 1Q18 Quarterly Inflation Report suggests a higher pass-through coefficient. The chart on the right below shows our simulations for 12-month inflation under two different assumptions for the BRL/USD exchange rate: at 4.30, the midpoint of next year's target would probably be missed.

Exchange Rate Pass-Through Coefficient (CPI Inflation)



12-Month Headline CPI Inflation (%), Scenarios



Sources: Santander estimates.

In-Depth Research: 2018 GDP Forecast Revised Downwards

In our September 12, 2018 report, *Standby Mode*, we revised our 2018 GDP growth estimate to 1.5% (from 2.0%). Even after the dissipation of most of the contractionary effects of May's truckers' strike, the Brazilian economy has been failing to gain momentum, both for domestic and external factors.

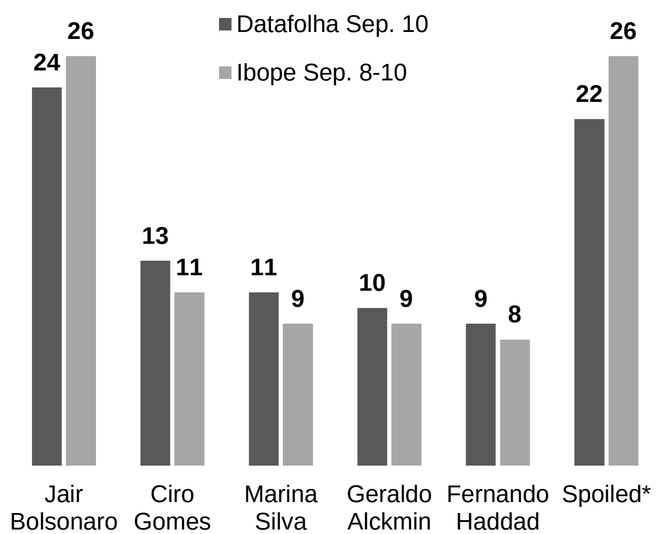
Firstly, the past few months showed a marked increase in risk perception in the global environment, with the rising of protectionist measures and currency crises in Argentina and Turkey adding to market volatility, decreasing risk appetite for emerging market assets, and deteriorating financial conditions. Domestically, uncertainties surrounding the elections and the future of economic policy (especially the perspective of reforms and fiscal consolidation) have been, in our view, contributing to lower business and consumer confidence and to the postponement of consumption and investment decisions, with consequences to economic growth.

However, the Brazilian economy still has some elements of relative strength: inflation remains contained; there has been little need of external financing; and credit markets have seen some improvement. With that in mind, we maintained our 2019 GDP growth forecast at 3.2% — contingent upon the continuity of the ongoing fiscal consolidation process, which will probably depend on the outcome of the October elections and the following policy signaling.

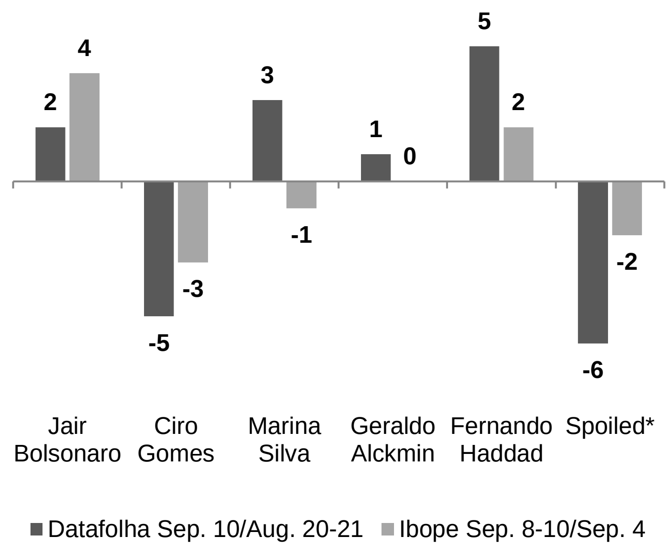
Political Agenda: Diverging Polls

Both Datafolha and Ibope, Brazil's largest pollsters, released new electoral polls this week. Results are summarized in the charts below – the differences between the two polls raise questions about the polls' relative accuracy or if there was some dislocation in voting intentions between Ibope's interviews (between September 8 and September 10) and Datafolha's (all made on September 10). New polls, to be released between September 14 (Datafolha) and September 18 (Ibope) may shed more light over those questions.

First Round Voting Intentions (%)



Changes in Voting Intentions (pp)



Sources: Santander estimates.

Number of the Week

6.4 pp

Senate's Independent Financial Institution estimates that Brazil's GDP was running 6.4 pp below potential on 2Q18. The so-called output gap narrowed by 1.9 pp since the bottom of the recession, on 4Q16.

Quote of the Week

"There has been a relevant change in corporate tax rates around the world, and Brazil should follow."

— **Eduardo Guardia**, finance minister, in an interview with *Estadão* (September 13, 2018).

What We've Been Reading

- "'Robin Hood in reverse': the crisis in the Brazilian state," by Jonathan Wheatley and Andres Schipani (*Financial Times*, September 13, 2018). Brazil's fiscal reform agenda also needs to address the current perverse distributive effects of government transfers.
- "Lula's Successor May Not Be the Bogeyman That Brazilian Investors Fear," by Mario Sergio Lima, Simone Preissler Iglesias, and Vinicius Andrade (*Bloomberg*, September 12, 2018). An assessment of Fernando Haddad's potential market-friendly credentials.
- "How a Candidate's Stabbing Will Further Radicalize Brazil," by Eduardo Mello (*Foreign Policy*, September 7, 2018). "The reason so many voters support radical change is because they have lost any hope that the current political system can be reformed from within."

- "Outperformers: High-growth emerging economies and the companies that propel them" (*McKinsey Global Institute*, September, 2018). A thorough analysis of what led 18 emerging economies (none west of the Greenwich meridian) to sustain strong growth over the past decades.

- *Sovereign Debt: A Guide for Economists and Practitioners* (IMF Conference, September 13-14, 2018). The building of an interesting new book, several preliminary chapters available.

Recent Publications (Available on Our Website)

- *Standby Mode* (September 12, 2018)
- *Worse Financial Conditions at the Margin Reinforce the Likelihood of Selic Remaining "Low for Long"* (August 30, 2018)
- *We're Not in 2002 Anymore (Caution Advised, Though)* (August 28, 2018)
- *The Power of Trade-Off* (August 2, 2018)
- *It's Not for a Lack of Credit—Part III: Delinquency, Way Better Than It Seems* (July 20, 2018)

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