Santander Corporate & Investment Banking

ECONOMICS

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Brazil Macro Compass

Copom: We See Tranquility after the Storm

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Upcoming Data: Monetary Policy Decision

Brazil's monetary policy committee (Copom) meets on October 31 for a rate decision that should be trivial, in our view. After Copom has resisted hiking rates since May under much worse financial conditions, we believe the recent relief in financial markets (see the table below), if confirmed after the results of Sunday's presidential run-off, should strengthen Copom's resolve to keep the overnight policy rate (Selic) at 6.50%. Recent CPI data have confirmed that the recent rise in tradable prices (fuel, mostly) has not been transmitted to core inflation (which remains around 3% y/y), evidence that the still-wide output gap and the slow recovery in the job market have been attenuating the pass-through effect. The stability of 2019 and 12-month inflation expectations also helps strengthen our view that the Central Bank has been mostly right in its economic diagnoses and monetary policy prescription – inflation has been kept stable and around the target midpoint at a relatively low cost in terms of interest rates. The recent flattening of the yield curve has shown, in our view, that the steepness had more to do with risks associated with the elections and the future of fiscal consolidation than with excessively loose monetary policy, and the low policy rate gave the Treasury the option of funding itself at a lower cost under market stress – such are the benefits of a credible Central Bank.

We believe that the Selic rate will stay at 6.50% until the end of 2019 (see "In-Depth Research" on page 2 of this report for more information). The next monetary policy decision – the last under the current government – is scheduled for December 12.

Selected Financial and Economic Indicators, Changes Between Copom Meetings

Market prices	**19-Sep**	**26-Oct**	**Change**
BRL/USD rate	4.13	3.72	-9.8%
5-year CDS	278	214	-64 bps
1-year rate	8.15%	7.28%	-87 bps
1-year breakeven inflation	4.25%	4.20%	-5 bps
5-year rate	11.70%	9.90%	-180 bps
Crude oil WTI (USD)	71	67	-5.3%
Crude oil WTI (BRL)	293	251	-14.6%
CRB Food (USD)	330	332	0.6%
CRB Food (BRL)	1,364	1,238	-9.2%
Market expectations*	**21-Sep**	**19-Oct**	**Change**
2018 CPI inflation (12m, year-end)	4.28%	4.44%	16 bps
2019 CPI inflation (12m, year-end)	4.18%	4.22%	4 bps
12-month CPI inflation, year ahead	4.04%	4.02%	-2 bps
2018 GDP growth	1.35%	1.34%	-1 bps
2019 GDP growth	2.50%	2.49%	-1 bps

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

In-Depth Research: Scenario Updates

In *Brazil Post Elections: Honeymoon and Marriage* (October 25, 2018), we introduced a new scenario for the main economic variables in 2018 and 2019. We expect the end of the general elections, with the election of a new president, to trigger a wave of improvement in asset prices, confidence, and market expectations, with more concrete announcements about the macro policies to be pursued in the next few years helping to curb perceived uncertainty. We changed our BRL/USD year-end forecasts to 3.50 and 4.00 for 2018 and 2019, respectively (from 3.80 and 4.10). With a stronger and more stable exchange rate, we believe next year's inflation will stay below the target midpoint (our 2019 year-end CPI inflation estimate moved to 4.0%, from 4.1%), which will, in our view, allow the Central Bank to stay on hold for longer. We now believe that the Selic rate will end 2019 at the current level (6.5%, versus 7.5% before the revision). A key condition for the unfolding of this relatively bullish scenario is the approval of pension reform early next year, as we believe that is both a necessary step toward fiscal consolidation and a signal that the next government will have the willingness and ability to keep adjusting its accounts.

What's New: IPCA-15, Job Creation

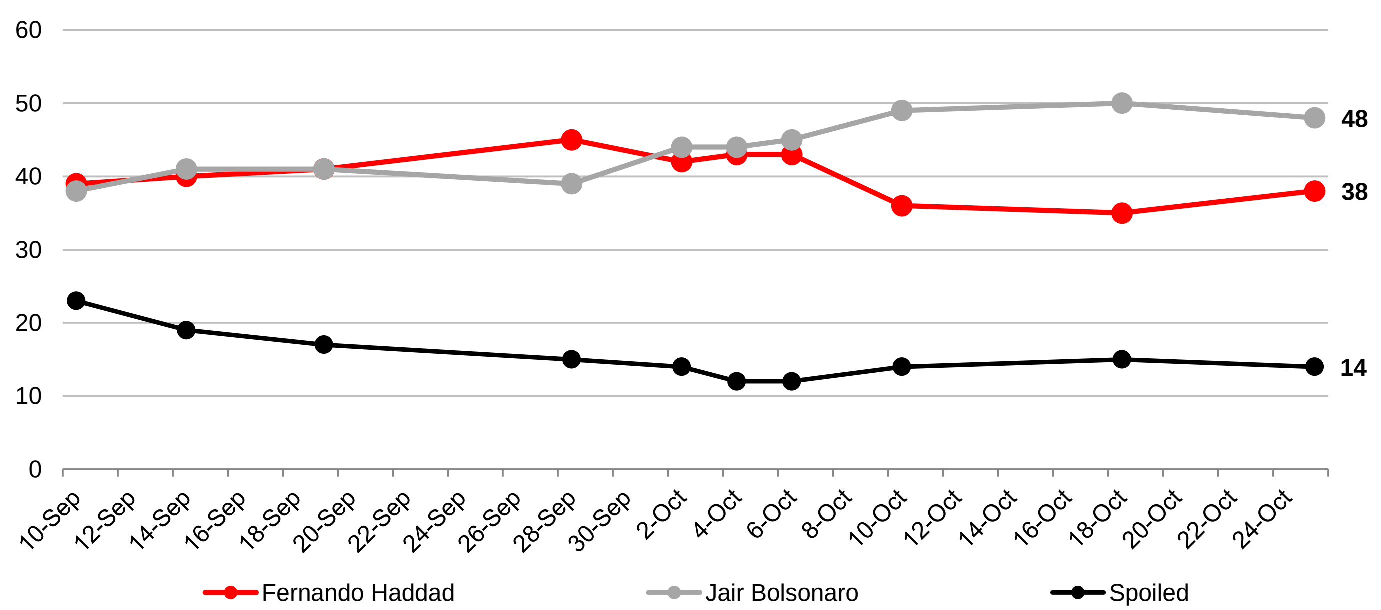
October IPCA-15 came in at 0.58% m/m, 8 bps below market consensus, with a milder than expected rise in foodstuff prices. Fuel prices continue to be the main culprit behind rising headline inflation this year – higher gasoline and ethanol prices contributed about half of monthly inflation. In contrast, core inflation remains relatively low and stable, at around 3% y/y. We expect headline CPI inflation to end 2018 at 4.3% y/y.

Net formal job creation surprised on the upside in September, with the net hiring of 137k workers (consensus was 82k). In seasonally adjusted terms, the monthly average of job creation in the past three months accelerated from 22k jobs to 49k jobs – a pace still slow in absolute terms, but consistent with some potential acceleration in economic activity in the near future.

Political Agenda: Presidential Run-Off Elections

The presidential election will be decided on Sunday (October 28), in a run-off between Jair Bolsonaro and Fernando Haddad. Ibope and Datafolha polls released this week showed a tightening in Bolsonaro's lead, to 13 pp in total votes according to Ibope (from 15 pp on October 15) and 10 pp according to Datafolha (from 15 pp on October 18 – see chart below). Exit polls and preliminary results can only be released on Sunday after 7PM Brasília time, when voting ends in the westernmost parts of the country.

Presidential Election Run-Off, Voting Intentions (% of Total Votes)

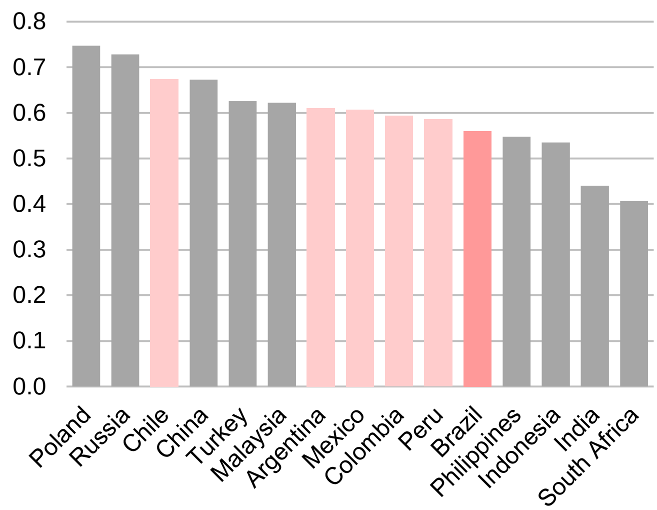


Note: Spoiled votes refer to the sum of declared null, blank, and undecided. Source: Datafolha.

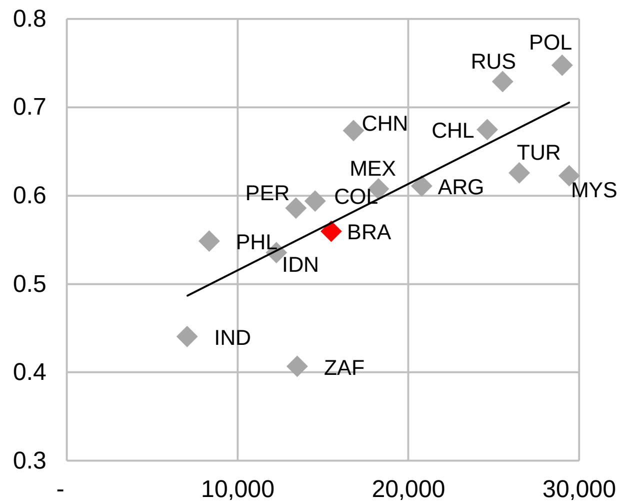
Chart of the Week: Human Capital

The World Bank recently released its Human Capital Index for 157 countries, an aggregation of indicators related to health, knowledge, and skills (such as probability of survival, schooling, and nutrition) that aims at summarizing the capabilities (in the sense used by economist Amartya Sen) of people living in different places and "to help create the political space for national leaders to prioritize transformational human capital investments." Our "Chart of the Week" looks at how Brazil and other Latin American and emerging countries score in that indicator (which ranges from zero to one), and how it correlates with per capita income. Latin American countries have, in general, a Human Capital Index score in line with or higher than what their per capita income would predict in a linear model.

The World Bank's Human Capital Index (2018)



Human Capital Index vs. GDP per Capita (USD PPP)



Sources: The World Bank, Santander.

Number of the Week

7.6

The average expected years of school for a Brazilian child, when adjusted by learning (as evidenced in harmonized test scores), are 7.6 years – less than the average of the same indicator for upper-middle-income countries (8.1 years) and more than three years behind children in high-income countries (10.8 years). Data from the World Bank's Human Capital Index (see more in the "Chart of the Week" above).

Quote of the Week

"No government did what was necessary in terms of public education, healthcare, sanitation, housing. Neither the military, nor the populists, nor the democrats."

— **Riordan Roett**, political science professor emeritus at Johns Hopkins University, in an interview with *Valor Econômico* (October 26, 2018).

What We've Been Reading

- "Brazil's hedge fund boom raises fund concentration risk," by Atholl Simpson (Citywire Americas, October 16, 2018). Booming flows into Brazil's *multimercado* funds have been concentrated among a handful of money managers.

- “The Sad Decline of Brazil’s Political Establishment,” by José R. Cárdenas (*Foreign Policy*, October 19, 2018). Cárdenas argues that a weak economy and massive corruption scandals tainted Brazil’s political class and opened the door for anti-establishment candidates.

- “The squadron of ex-military men behind Bolsonaro's rise in Brazil,” by Brad Brooks and Anthony Boadle (*Reuters*, October 23, 2018). Retired army generals are strong influencers in Jair Bolsonaro’s campaign and government plan.

- “Is Latin America Facing a Wave of Right-Wing Populism?” by Cristóbal Rovira Kaltwasser (*Project Syndicate*, October 23, 2018). Bolsonaro’s rise does not closely follow the pattern of populist triumphs in Europe and the U.S., according to the author.

- “Populism in Mexico and Brazil: why are voters moving in opposite directions?” by Rodrigo Aguilera (*LSE Latin America and Caribbean Centre Blog*, October 24, 2018). Race, religion, and fragmentation of the political system are key differences between the two countries that may help to explain why different kinds of leaders look more appealing to the populations of Brazil and Mexico, according to Aguilera.

- “Mexico’s AMLO and Brazil’s Bolsonaro: very different . . . and very similar,” by Moisés Naím (*The Global Observer*, October 22, 2018). Naím focuses on the similarities between the two politicians – “a deep disdain for the rules and institutions that limit the power of the president,” among others.

Recent Publications (Available on Our Website)

- *Brazil Post Elections: Honeymoon and Marriage* (October 25, 2018)
- *Brazil – Risk Premium: Apples and Oranges* (October 9, 2018)
- *BRL: Between Common and Idiosyncratic Factors* (September 26, 2018)
- *Copom: Hoping for the Best but Prepared for the Worst* (September 17, 2018)
- *Economic Activity: Standby Mode* (September 12, 2018)

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