

Brazil Macro Compass**BCB Stays on Hold; We Forecast a Flat Selic Rate Throughout 2019**

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What's New: Monetary Policy Decision, Industrial Production

Brazil's Central Bank (BCB), in line with market consensus, kept the overnight rate (Selic) at 6.5% p.a., in a unanimous decision. According to BCB's models, 2019 projected inflation using input variables at market consensus rose to 4.2% (from 4.0% in September); we believe this is probably why the statement highlighted that risk factors that may contribute to higher inflation in the future now have greater weight in the bank's baseline scenario. For the first time, the statement mentions 2020 inflation as part of the "relevant time horizon" for the conduct of monetary policy. BCB's model forecast for 2020 inflation sits comfortably at 3.7%. The minutes of the meeting will be released next Tuesday.

As in September, BCB reaffirmed that the economic outlook still prescribes a stimulative monetary policy and that a tightening cycle could begin if the outlook deteriorates from here. The committee now sees a more even balance of risks compared to September, probably reflecting looser financial conditions and lower oil prices, in our view.

We believe that BCB will stay on hold in the next Copom meeting (on December 12) and throughout 2019. In our view, the still wide output gap (around 4% of GDP) should contribute to keep core inflation significantly below the inflation target midpoint, with headline inflation probably benefiting in the next few months from the recent BRL strengthening and falling oil prices. The target undershooting in 2020 under a Selic rate at 8.0%, suggested by the forecasts introduced in the statement, helps to reinforce our call, in our view.

October industrial production, released this week, fell 1.8% m/m, more than market consensus (-1.0% m/m). The auto industry contracted 6.4% in the month (despite less disappointing leading indicators), which explains the major part of the poor performance. We expect industrial production growth to accelerate to 3.5% y/y by year-end.

Upcoming Data: October IPCA

October CPI inflation (IPCA) will be released on November 7. We expect monthly inflation at 0.42% (vs. 0.48% in September), reflecting some relief on foodstuff and fuel prices (the latter on the back of a strengthening BRL and falling crude oil prices). We expect yearly inflation to fall to 4.3% (from 4.5% currently) by year-end, with highly favorable dynamics for core inflation (stable at around 3% y/y) and further disinflation in non-core items. The strong rains seen in the past few months should help to reduce November inflation, in our view, with the announcement of a reduction in the surcharge on electricity tariffs associated with hydrological risk (the flag system).

Political Agenda: President-Elect Bolsonaro

Jair Bolsonaro won the run-off election for president last Sunday, beating Fernando Haddad by a little more than 10.7 million votes (55.13% vs. 44.87% of valid votes, in line with the polls released the day before voting). In his first TV speech as president-elect, Bolsonaro stated that "liberty is a fundamental principle," and directed the economic agenda of his government toward job creation, income growth, and fiscal discipline (see the "Quote of the Week" on page 3 of this report).

Discussions about potential nominations for the cabinet and state-owned firms dominated the news flow this week, although no official announcements were made besides what was already known (Paulo Guedes will become finance minister, in a new "super-cabinet" that we believe will probably also incorporate the agendas of two other current ministries – the Planning Ministry and the Ministry of Development, Industry, and Foreign Trade).

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.

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In our view, the most important signals to markets in the next few weeks should come from nominations to the Central Bank and details about the new government’s plan to reform the pension system. Bolsonaro’s inauguration is scheduled for January 1, 2019. A transition team, formed by up to 50 people, will start working with the current government in Brasília beginning next Monday (November 5).

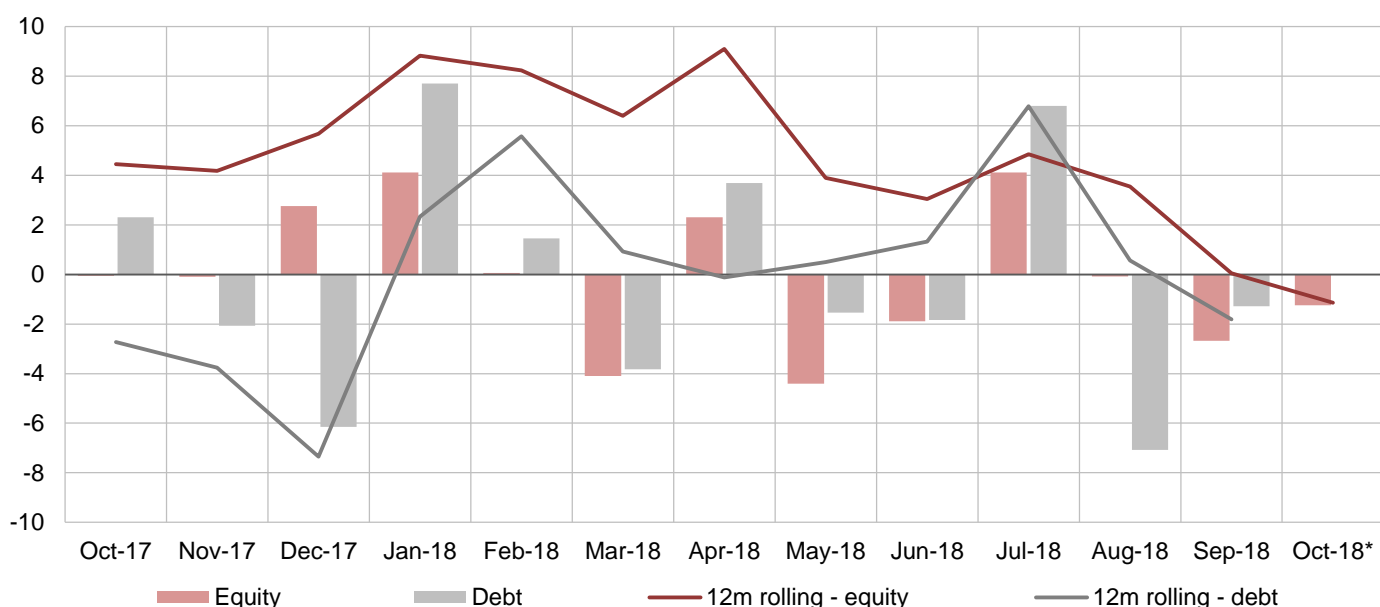
In-Depth Research: Shifts in Political Power

In *20 Charts that Explain Brazil’s New Political Power Structure* (October 29, 2018), we show how political power shifted in Brazil with the general elections concluded last Sunday. Looking at state government and congressional elections, power is now more fragmented (12 parties will have at least one state governor; 30 parties will have representatives in the Lower House) and skewed to the right. Traditional center-right parties lost ground to Jair Bolsonaro’s Social Liberal Party (PSL) and other emerging forces, whereas, notwithstanding losing the presidency, the Workers’ Party (PT) and other left-wing parties managed to keep a considerable minority in both houses of Congress and in the state governments.

Chart of the Week: Portfolio Flows

According to the most recent estimates from the Institute of International Finance (IIF), non-resident portfolio outflows to Brazilian equities amounted to USD 1.2 billion in October, bringing 12-month cumulative flows into negative territory for the first time since July 2009. Emerging markets equities saw the largest outflow from non-residents in a month (USD 17.1 billion) since June 2013, after the “taper tantrum.” On the debt side, figures for October are still not available, but flows in the 12 months through September have been erratic, adding up to a USD 2 billion outflow.

Net Non-Resident Portfolio Flows to Brazil (USD billion)



*Preliminary data for equities, debt data still not available. Sources: IIF, Santander.



Number of the Week

9.6%

9.6% of Brazilian voters voted null or blank in the presidential run-off election, the largest share of such votes since the reinstatement of free presidential elections in 1989. In 2014, nulls and blanks added up to 6.3% of total voters.

Quote of the Week

“We will break the vicious circle of growing debt, replacing it with the virtuous circle of smaller deficits, declining debt, and lower interest rates.”

— **Jair Bolsonaro**, Brazil’s president-elect, in his first TV speech after the elections (October 28, 2018).

What We’ve Been Reading

- “Can Brazil’s Growth Bounce Back?” by Sergi Lanau, Martin Castellano, and Gregory Basile (*IIF Economic Views*, October 30, 2018). Reforms to boost investment will be instrumental in a stronger economic recovery, the authors argue.
- “Trumpism comes to Brazil,” by Roberto Simon and Brian Winter (*Foreign Affairs*, October 28, 2018). According to Simon and Winter, Bolsonaro’s foreign policy should bring Brazil closer to the U.S. and further away from Venezuela.
- “How the unthinkable happened in Brazil,” by Fernando Henrique Cardoso (*The WorldPost*, October 29, 2018). “Of the four presidents elected after the 1988 Constitution took effect, two were impeached, one is in jail for corruption and the other is me,” Cardoso writes.
- “Brazil Super Minister Shoulders Weight of Bolsonaro Economy,” by David Biller, Cristiane Lucchesi, and Rachel Gamarski (*Bloomberg*, October 30, 2018) and “Can Paulo Guedes Deliver in Brazil?” by Emilie Sweigart (*Americas Quarterly*, October 30, 2018). Two good profiles of the soon-to-be finance minister.
- “Brazil’s Markets Have Surged on Hope of Bolsonaro Victory. Can He Deliver?” by Shasta Darlington (*The New York Times*, October 26, 2018). The multi-million-dollar question to be answered over the next few months.
- “Brazil’s New President Faces Few Constraints,” by Filipe Campante (*Bloomberg*, October 29, 2018). Campante, a Brazilian professor at Johns Hopkins University, has a bleak view of the future of democracy in Brazil.

Recent Publications (Available on Our Website)

- *20 Charts that Explain Brazil’s New Political Power Structure* (October 29, 2018)
- *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)



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