Santander Corporate & Investment Banking

ECONOMICS

November 9, 2018

Brazil Macro Compass

Inflation Heading Down, with Relief for Fuel Prices

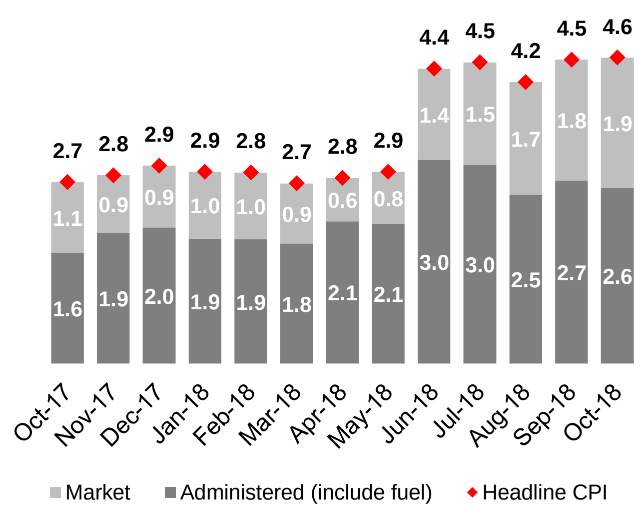
Luciano Sobral*
lusobral@santander.com.br
+5511 3553 3753

What's New: Below Consensus CPI Inflation

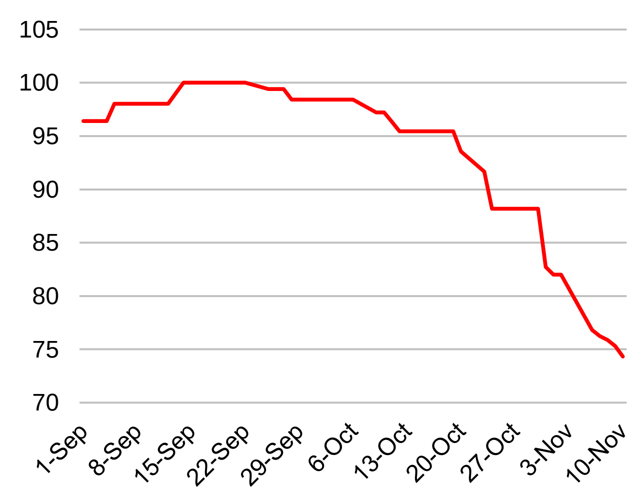
October CPI inflation, released this week, came in at 0.45% m/m, below market consensus (0.56% m/m) and in line with our forecast (0.42% m/m). 12-month headline ended October at 4.56% (from 4.53% in September). Transportation costs (including fuel) contributed 0.31 pp to monthly inflation, with foodstuff (+0.91% m/m) accounting for most of the residual.

We believe November data will show a steep decline in fuel prices: wholesale gasoline prices are already down more than 10% month-to-date (see chart below), reflecting falling international oil prices and a strengthening currency. Moreover, we also expect electricity tariffs to fall in the month, given the announced change to "yellow flag" in the surcharge system. In sum, we expect CPI to contract 0.13% in November, bringing 12-month inflation to 4.13%. We believe 12-month inflation will end 2018 below the target midpoint, at 4.3%. Moderate inflation should contribute to our scenario of "low for longer" for the overnight policy rate (see "In-Depth Research" below).

12-month CPI Inflation Breakdown (%)



Gasoline Price at the Refinery (100 = YTD peak)



Sources: IBGE, Petrobras, Santander.

In-Depth Research: Copom Minutes and Selic

In *Risks for the Selic in 2019 Expected to Become Even Less Asymmetric* (November 6, 2018), we reiterated our call of a stable Selic rate (at 6.50%) throughout 2019, after evaluating the risks mentioned in the minutes of the latest Copom meeting. Even considering an economic recovery stronger than current market consensus (we forecast 2019 GDP growth at 3.2%, versus the 2.5% median of the Focus survey), the output gap is likely to remain disinflationary, with the unemployment rate ending 2019 still above our best estimate for the NAIRU (10% vs. 9.5%). We also have a positive take on the recent discussions regarding granting the Central Bank formal independence (see "Political Agenda" on page 2) — if this does indeed materialize, that could strengthen the credibility of the monetary authority and further improve market expectations. Finally, we believe that median inflation expectations are still due a downward adjustment, following the recent fall in fuel prices (see "What's New" on page 1), the incorporation of forecasts of a stronger BRL into inflation models, and continuing low core inflation measures.

Upcoming Data: 3Q18 Activity Indicators

The cycle of high frequency economic activity data regarding 3Q18 ends this week. In general, we believe the economy expanded at a slow pace in September, weighing in the uncertainties associated with the October presidential elections.

We expect a 0.4% m/m growth in core retail sales (2.2% y/y), to be released next Tuesday. For the headline indicator (including the auto and construction material sectors), we expect a 2.2% contraction in the month, smoothing out the strong growth in August (4.2% m/m). Still, we expect this broad measure to continue growing ahead of the core index in yearly terms (+3.5% y/y), reflecting a relatively strong growth recovery in auto sales.

We expect the volume of services (out next Wednesday) to feel the impact of industrial production's poor performance in the period, as sectors such as transport and information services are highly correlated with that indicator. We expect a 0.2% monthly contraction.

Finally, on Friday the Central Bank releases its monthly GDP proxy, IBC-Br. We forecast 1.5% yearly growth, which corresponds to a flat 3Q18. We expect a rebound in economic activity on 4Q18, led by the recent improvement in financial conditions, the labor market recovery and confidence boost following the election.

Political Agenda: What Is Left for the Congress This Year?

The Brazilian Congress has only five working weeks (discounting the week of the Republic Day holiday, on November 15) until the beginning of the summer recess. Some relevant economic themes in discussion include:

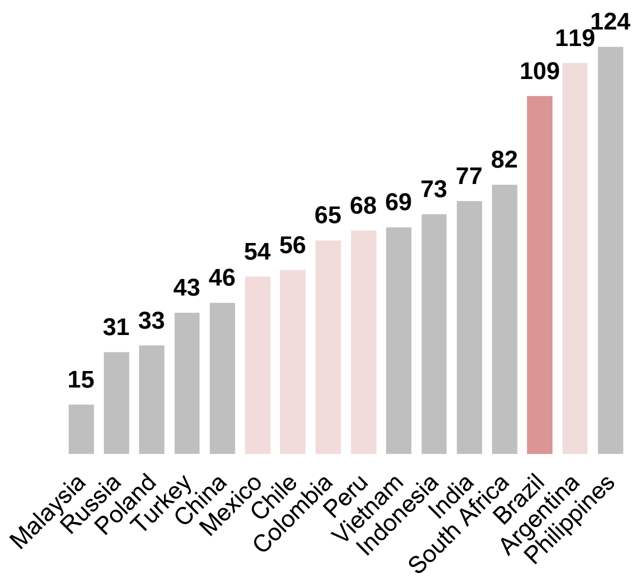
1. **Transfer of oil exploration rights (*cessão onerosa*):** The Senate tried to approve this week an urgency request for the voting of the bill that allows the auctioning of oil fields in the Santos basin. The request was blocked by the opposition, and a new voting on the request is expected to November 20 (if approved, the bill can go to a floor vote in the following day). In any case, there will probably be no time for the fiscal revenue from the auctions (estimated at between BRL 80 billion and BRL100 billion by the Ministry of Mines and Energy) to be added to this year's balance (the incoming government may be benefited by such revenue in 2019, if the conditions for the auctions materialize).
2. **Pension reform:** Pension reform discussions are back, although there still seems to be no consensus about what kind of measures can be proposed to Congress. We believe the probability of approval of a meaningful reform this year are to be low, given the tight calendar and the difficulty in providing incentives to a large share of representatives and senators that did not get reelected. We expect the pension reform to be the top priority of the incoming government early next year, though.
3. **Central Bank independence:** This week the Central Bank governor, Ilan Goldfajn, and the speaker of the Lower House, Rodrigo Maia, met to discuss the possibility of still holding a vote this year on a bill that would give the Central Bank formal independence. According to the press (see, for example, "Equipe de transição negocia independência do Banco Central," *Agência Brasil*, November 8, 2018), this theme has also support from the incoming government. The bill to be re-discussed (PLP 32/2003) is authored by Rodrigo Maia himself, was first presented in 2003 and is pending a reading opinion from the rapporteur at the Finances and Taxing committee of the Lower House. The proposal also includes a fixed tenure for the governor (four years) and board members (seven years), with the governor's tenure not coinciding with the presidential mandate.

The current legislative year ends on December 22. The newly elected Congress starts working on February 2, 2019, with the election of speakers of both houses as its first task.

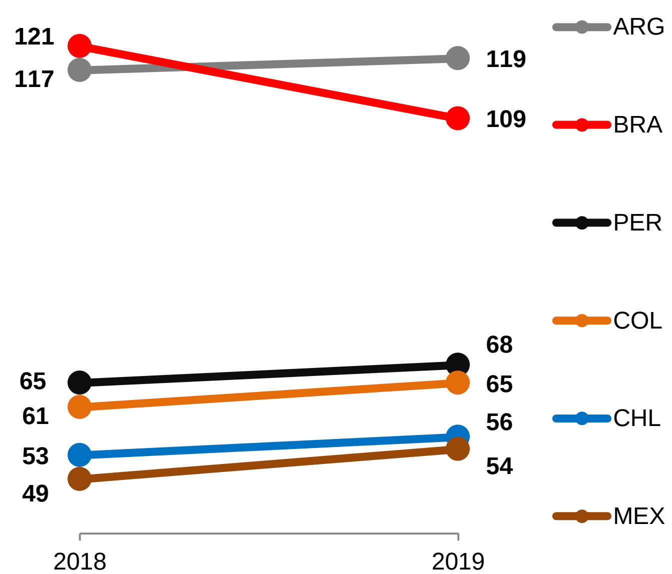
Chart of the Week: Doing Business Ranking

On October 31, te World Bank released the 2019 update of its flagship *Doing Business* report. The report compares indicators of business regulation and protection of property rights across 190 economies over time. In the ranking of the aggregated indicator "ease of doing business score", Brazil ranked 109, its the best position since 2014 and up 12 positions relative to the 2018 release. Despite being the only large Latin American country that moved up in the ranking in the period, Brazil still has one of the worst business environments among large emerging economies.

Doing Business 2019 – Ease of Doing Business Rank



Ease of Doing Business Rank, 2018 vs. 2019



Sources: The World Bank, Santander.

Number of the Week

-10.1%

The wholesale price of gasoline sold at the Brazilian refineries fell 10.1% so far this month, which should contribute to a retraction in headline inflation by year end. See "What's New" on page 1. Wholesale gasoline price is down 26% from this year's peak, in September.

Quote of the Week

"Keeping a pay-as-you-go pension system is a crime against the future generations."

— **Paulo Guedes,** Jair Bolsonaro's appointment to the Ministry of Finance, in an interview with Bandeirantes TV (November 5, 2018).

What We've Been Reading

- *Doing Business 2019: Training for Reform* (The World Bank, October 31, 2018). Update of the bank's flagship report on business practices, see the "Chart of the Week" above.

- *Inflation in Emerging and Developing Economies: Evolution, Drivers, and Policies* (The World Bank, November 7 2018). A new comprehensive book edited by the World Bank, including a soon-to-be released dataset covering inflation in more than 175 countries.

- "Brazil's new finance minister eyes 'Pinochet-style' fix for economy," by Andres Schipani and Joe Leahy (*Financial Times*, November 2, 2018). Paulo Guedes, the incoming finance minister, claims that the Chicago Boys saved Chile.

- "Brazil's new president: strongman at home, weak man abroad?" by Harold Trinkunas (*Order from Chaos*, October 31, 2018). The next government will have to deal with Brazil's eroding "soft power" abroad, argues Trinkunas.

- "Brazil is unpredictable right now. Here are 3 possible scenarios for incoming president Jair Bolsonaro," by Ryan Lloyd (*Monkey Cage*, November 7, 2018). Lloyd believes that the best possible outcome for the next government would be mediocrity, as extreme success or failure would increase the risk of political instability.

Recent Publications (Available on Our Website)

- *Risks for the Selic in 2019 Expected to Become Even Less Asymmetric* (November 6, 2018)
- *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)

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.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, Peru	diana.ayala@santander.us	212-407-0979
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	5982-1747-5537
Fixed Income Research			
Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan 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
David Franco*	Macro, Rates & FX Strategy – Latin America	david.franco@santanderCIB.co.uk	44-207-756-6633
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
Nicolas Schild*	Head, Chile	nschild@santander.cl	5622-336-3361
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Cecilia Jimenez*	Head, Mexico	mcjimenez@santander.com.mx	5255-5269-2228

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
Corporate & Investment Banking