ECONOMICS March 22, 2019

Brazil Macro Compass

Copom: Still "Caution, Serenity, and Perseverance"

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

What's New: Copom Decision

Brazil's Monetary Policy Committee (Copom) decided to hold the Selic rate at 6.5%, as widely expected. The statement following the decision brought some significant changes: (i) The committee recognized that economic activity has been recovering at a slower pace than previously expected; and (ii) risks to the inflation scenario are now considered symmetric – i.e., Copom attributes equal weight to risks that could lead inflation to undershoot or overshoot the target. Finally, the committee stated that it needs more time to obtain a clearer appraisal of the economic scenario (given the several shocks that affected the economy last year), a task unlikely to be completed in the short term.

This statement, in our view, prepares the market for an occasional residual easing cycle; albeit this, in our view, is still heavily conditioned upon market conditions and the 2020 inflation outlook, and is not expected to happen in the next rate decision (May 8). Beyond that, we believe that uncertainties related to the reform agenda should continue to lead the Central Bank to take a cautious approach to monetary policy. **We still predict that the Selic rate will stay unchanged until late 2020**, at which time the narrowing output gap and inflation approaching the target midpoint should lead to a tightening cycle. However, it is fair to recognize that the probability of that happening only after some small rate cuts has increased recently, with softer inflation and GDP growth forecasts.

Upcoming Data: Quarterly Inflation Report

Next week, the Central Bank will release the minutes of the last meeting and the Quarterly Inflation Report (QIR). Both documents are expected to only reinforce the changes made in the aforementioned post-meeting statement.

Regarding inflation forecasts, we expect only a few changes. With respect to the reference scenario, which considers a constant Selic and exchange rate (6.5% pa and BRL3.85/USD), official projections in the December QIR were 4.0%, 4.0% and 4.1 % for 2019, 2020 and 2021, respectively. As the short-term inflationary surprise was low and the exogenous variables did not change (see "Chart of the Week" for details), the new forecasts should remain relatively stable, at 4.1%, 4.0% and 4.0%, in the same order. That is, only 2021 inflation is above the established Central Bank target (of 3.75%).

March IPCA-15 will be released on Tuesday. We expect monthly inflation to accelerate to 0.54% m/m. According to our projections, the main driver of this acceleration will be food inflation, increasing from 0.68% m/m to 1.65% m/m, due to heavy rainfall during the month. Conversely, the services group should increase 0.32% m/m, slowing down after the end of the impact of school tuition fees. As a result, we expect 12-month inflation to rise to 4.18% from 3.73% in the previous month, still in line with the target (4.25% in 2019). Core inflation should remain subdued, despite the acceleration to 3.0% y/y at the margin (3-month seasonally adjusted annualized rate).

Political Agenda: The Military Draft

This week, the government presented its proposal to reform the pension system for the military. According to government estimates, expected savings from the overhaul of retirement rules total BRL97.3 billion over 10 years, but a restructuring of careers in Brazil's armed forces (compensation for past distortions in military wages and benefits) will cost BRL86.9 billion in the same period. Thus, the net savings from the changes proposed today correspond to BRL10.5 billion in 10 years. These figures were disappointing, in our view, since our previous expectation of net savings from new military's pension system was around BRL 90 billion.

We continue to see potential for the approval of a pension reform with savings of around BRL800 billion in 10 years, which means a watering down rate of around 30% in comparison to the overall expected savings published by government last month (total of BRL1.16 trillion). However, we acknowledge that the balance of risks for the pension reform's fiscal impact has worsened recently — not only because the release of lower net savings from the military pension reform, but also due to rising pressure from civil public servants (which could ask for some restructuring of careers to offset changes in their pension system) and still substantial uncertainty about the political coordination of Bolsonaro's government**.**

The Lower House's Constitutional Committee started examining the overall pension reform draft this week. According to the committee's head, Felipe Francischini, the final report is expected to be presented on March 26 and voted on April 3. After that, the proposal must be examined by a special committee, still to be constituted.

Chart of the Week

Our "Chart of the Week," shows our perspective for medium-term inflation forecasts that will be released in the Quarterly inflation report next week. Under the market scenario, we should observe some increase in inflation projections because of lower Selic rates for 2019 and 2020. Otherwise, in the reference scenario, inflation forecasts will remain almost stable compared to the December Inflation Report, as the main exogenous variables did not change.

Central Bank: IPCA Forecasts

Period	QIR Dec/18		QIR Mar/19	
	Market Scenario	Reference Scenario	Market Scenario	Reference Scenario
2019	3.90%	4.00%	3.90%	4.10%
2020	3.60%	4.00%	3.80%	4.00%
2021	3.70%	4.10%	4.00%	4.10%
Variables				
BRL/USD 2019	3.80	3.85	3.70	3.85
BRL/USD 2020	3.80	3.85	3.75	3.85
BRL/USD 2021	3.86	3.85	3.80	3.85
Selic 2019	7.50%	6.50%	6.50%	6.50%
Selic 2020	8.00%	6.50%	7.75%	6.50%
Selic 2021	8.00%	6.50%	8.00%	6.50%

Sources: Central Bank, Santander.

Number of the Week

BRL 1.8 bn

Prosecutors estimate that the corruption scheme of which former President Michel Temer was arrested for this week siphoned off BRL1.8 billion from public coffers.

Quote of the Week

"*The president loves Americans. Me too of course. We love Disneyland and Coca Cola.*"

— **Paulo Guedes**, Minister of Economy, during president Bolsonaro's official visit to the United States (*Reuters,* March 18, 2019).

What We've Been Reading

- "The Tropical Trump? If He's Lucky," by Brian Winter (*Americas Quarterly*, March 20, 2019). Bolsonaro needs to start to deliver on crime reduction and job creation if he wants to emulate the success of his role model, argues Winter.
- "Bretton Woods at 75," by Arminio Fraga (*Project Syndicate*, March 18, 2019). Global financial cooperation mutated since the famous post-war agreement, but continues to provide a global public good, argues the former Brazil Central Bank governor.
- *Brazil: Boom, Bust, and Road to Recovery*, edited by Antonio Spilimbergo and Krishna Srinivasan. IMF's new book on the past and future of the Brazilian economy.

Recent Publications (Available on Our Website)

- *Is Monetary Policy Stimulative for Consumption?* (March 6, 2019)
- *Lower Inflation Forecast for 2019* (February 28, 2019)
- *Economic Activity: Is The Glass Half Empty or Half Full?* (February 27, 2019)
- *It's Show Time: The Battle for Social Security Reform* (February 20, 2019)
- *Economic Activity: Economic Derby—Rivals or Teammates?* (February 19, 2019)

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