Santander
Corporate & Investment Banking

ECONOMICS

March 29, 2019

Brazil Macro Compass

Past the Honeymoon

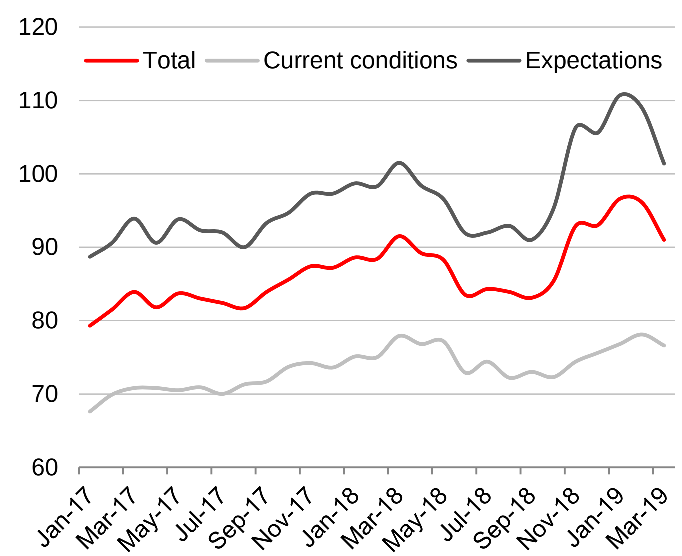
Luciano Sobral*
lusobral@santander.com.br
+5511 3553 3753

Charts of the Week: Falling Confidence and Its Effects

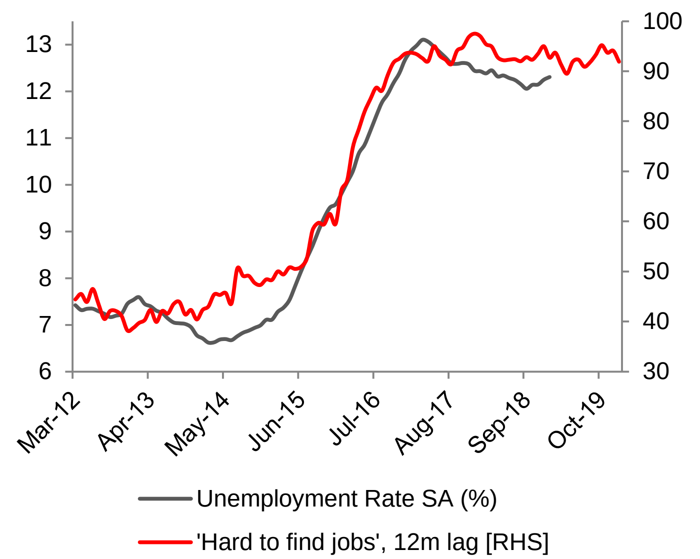
This past week may mark the moment when the honeymoon between markets and the new government, as we described in our report *Brazil Post Elections: Honeymoon and Marriage* (October 25, 2018), came to an end. In addition to the political turbulence (for more details, see the "Political Agenda" section of this report) and the consequent deterioration in expectations related to the content and timing of the pension reform (see the section "In-Depth Research" on page 2 of this report) and the decline in asset prices, the latest consumer confidence data showed that the confidence index took a substantial hit in March, led, in our view, by recent disappointments with the country's economic performance. According to our observations, the surge in confidence after the 2018 elections has not been reflected in "real-world" decisions on hiring, consumption, and investment, as evidenced by the recent poor performance of economic activity indicators and falling GDP consensus forecasts.

Our "Charts of the Week" take a deeper look at the confidence index calculated by FGV and updated this week. In March the headline index plunged 5 points to 91, the lowest level since its surge after the election of Jair Bolsonaro in October 2018. Comparing its components, it is clear (see the left-hand chart below) that most of the recent changes have been led by the "expectation" component, whereas the "current conditions" index has been virtually stable at a much lower level. We also note (in the chart at right below) the close correlation between one of the "current conditions" index's subcomponents and the unemployment rate – usually a high percentage of respondents answering that jobs are "hard to find" is associated with a high unemployment rate 12 months forward. If that relationship continues to hold up in the near future, it is likely that there will be little improvement in the current weak job market, with possible negative consequences for overall economic activity and for the government's popularity, in our view.

FGV Consumer Confidence Index (Seasonally Adjusted)



Unemployment Rate vs. Perceived Job Market Conditions



Sources: FGV, IBGE, Santander estimates.

Political Agenda: Executive-Legislative Tensions

Amid the myriad heated quotes and discussions that populated the political headlines this week, we highlight two concrete facts: first, leaders of 11 parties from the so-called *Centrão* group signed a note highlighting the importance and necessity of pension reform, but announcing that they proposed removing from the government's draft proposed changes in the retirement rules for rural workers and in the concession of a social benefit for poor elders and people with disabilities (BPC). The note, in our view, expresses some discontent with the government's proposal but also indicates the potential for a large block of representatives (around 280, or 55% of the total Lower House seats) to support a watered-down version of the reform, preserving its essential components (see the "In-Depth Research" section below). Second, unexpectedly and at an unusually fast pace, the Lower House approved in two rounds a constitutional amendment proposal from 2015 that may increase the federal budget's share mandatorily allocated to infrastructure projects proposed by the parties, thus reducing the already small share (less than 10%) controlled by the Ministry of Economy. Again, in our view, this piece of news has two sides: it goes against the general guideline set out by Minister Paulo Guedes to try to remove earmarking from the budget, but it also shows how the Lower House's leadership can be effective in expediting rules procedures for bills in which it takes an interest.

That is not to downplay the recent signs of poor coordination between the executive and the Congress – the President's hardening stance regarding the usual pork-barrel negotiations with lawmakers and decision not to distribute cabinet positions according to the Congress's party composition is probably not making the task of approving the pension reform any easier, in our view (as we note in the report summarized in the "In-Depth Research" section below). However, the Congress's majority has repeatedly shown an inclination to cooperate in the reform process, whereas the opposition has been relatively quiet. A course correction is still within reach for the executive, and success in the first floor vote in the Lower House in 2H19 is still feasible, in our view.

Lower House Constitutional Committee's president, Felipe Francischini, appointed Marcelo Freitas (from President Bolsonaro's Social Liberal Party, or PSL) as rapporteur of the pension reform proposal in that committee. Francischini mentioned that he expects the committee to conclude its appraisal of the reform on April 17, before the Easter holidays (and in line with our estimated timeline that puts a first floor vote at the end of August). The reform would then go to a special committee, still to be constituted.

In-Depth Research: New Pension Reform Savings Estimates

In *The Moment of Truth: From Intentions to Bargaining* (March 28, 2019), we update our estimates of the fiscal impact of the pension reform, in light of the most recent developments. **We now expect the final version of the reform (after being watered down in the Congress) to deliver BRL615 billion in savings over the first 10 years of its implementation,** down from our initial estimate of BRL800 billion (see our report *It's Show Time: The Battle for Social Security Reform*, February 20, 2019). In addition to the points opposed by a majority of the representatives (see "Political Agenda" above), which we assume will be removed from the proposal, we believe that savings derived from changes in the retirement rules for urban private workers and public servants will be cut by, respectively, 40% and 30% from the original draft, assuming changes in parameters such as the minimum retirement age for women, the transition rules, and the initial replacement rates for new retirees. As for the timing, we expect the reform to come a first floor vote in the Lower House by the end of August, assuming that the Constitutional Committee (CCJ) concludes its revision on April 17.

We acknowledge that the balance of risks for a timely approval of the bill has worsened recently: the likelihood of a more modest modified version seems higher than that of a more robust reform, and delays in the timeline are, in our view, more probable than positive surprises.

What's New: March IPCA-15, Central Bank Forecast and View Updates

March IPCA-15 came in at 0.54% m/m, in line with our forecast. With that, 12-month inflation jumped to 4.18% from 3.73%. The recent inflation acceleration is mostly explained by seasonal increases in produce prices, affected by heavy rains. Wholesale prices of such goods already show signs of reversing, leading us to believe that our current forecasts for year-end (3.5% y/y headline inflation) will still hold. Core inflation continues running well below the headline, at around 2.5% y/y at the margin (three-month seasonally adjusted and annualized measures).

Brazil Central Bank (BCB) published the minutes of last week's monetary policy meeting and its quarterly inflation report. The minutes corroborate our view that the overnight Selic rate will stay at the current level (6.5%) for a prolonged period. BCB reiterated the importance of observing how the economy will behave in the absence of last year's confidence shocks, noting that such an assessment cannot be concluded in the short term. According to the document, many key input variables for the monetary policy decision (pace of economic recovery, inflation expectations, asset prices, and the neutral interest rate) depend on the unfolding of the economic reform agenda, which leads us to believe that the monetary authority is likely to remain cautious until the uncertainties surrounding the pension reform process dissipate. The next rate decision is scheduled for May 8.

The quarterly inflation report presented a revision of BCB's expected GDP growth for this year, now at 2.0% (from 2.4%). The central bank also released its estimates for short-term inflation (IPCA m/m at 0.55%, 0.48%, and 0.41% in March, April, and May, respectively) and reported the results of its models for year-end 2019, 2020, and 2021. In the scenario assuming Selic and exchange rates at market consensus, BCB forecasts 12-month inflation within the 3.8-3.9% range until the end of 2021, which corroborates our view that the Selic rate will stay on hold for a long period.

Upcoming Data: February Industrial Production

According to our estimates, industrial production grew 0.5% m/m (1.6% y/y) in February, recovering part of January's poor performance but decelerating from the same period in 2018 (1.4% m/m). Motor vehicles production data already released points to a nice rebound from a notably poor 4Q18 (aggregate January/February production was 12% higher than November/December, after seasonal adjustments, and 5% higher than in the same period of 2018), and we believe that component should lead the headline index.

Number of the Week

448

448 Lower House representatives (87% of all seats) voted in favor of the PEC 2/15, a constitutional amendment that mandates the earmarking of a larger share of the federal government's budget intended for regional public investment at discretion of the House.

Quote of the Week

"*Brazil needs to get out of Twitter and go to real life. Nobody can get a job, a place at school, daycare, hospital because of Twitter.*"

— **Rodrigo Maia,** Speaker of the Lower House, in an interview with *O Estado de S. Paulo* (March 23, 2019).

What We've Been Reading

- "Elusive Economic Growth Points to Depth of Brazil's Problems," by Rachel Gamarski, Vinicius Andrade, and David Biller (*Bloomberg*, March 28, 2019). The recent lackluster economic performance is unlikely to improve unless more is done to tackle the country's habitual productivity issues, in the view of the authors.
- "The path to reform looks as rocky as ever for emerging economies," by Jonathan Wheatley (*Financial Times*, March 27, 2019). The pro-market reform agenda is stalling in some of the world's largest emerging countries, leading to lower growth prospects, argues Wheatley.
- "Jair Bolsonaro, Brazil's apprentice president," by Michael Reid (*The Economist*, March 28, 2019). Bolsonaro's stakes in the pension reform process go much beyond fiscal savings, according to Reid.
- "Jair Bolsonaro's Southern Strategy," by Jon Lee Anderson (*The New Yorker*, April 1, 2019 issue). A long-form account of how Bolsonaro became president and how his strategy and plans align with Donald Trump's.
- "36 Hours in Rio de Janeiro," by Nell McShane Wulfhart (*The New York Times*, March 28, 2019). Some nice things to do in Brazil's party capital.

Recent Publications (Available on Our Website)

- *Pension Reform – The Moment of Truth: From Intentions to Bargaining* (March 28, 2019)
- *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)

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