ECONOMICS

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Brazil Macro Compass

Inflation Starts Mid-Year Plunge

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What's New: May Inflation, April Industrial Production, May Auto Sales

May CPI inflation came in at 0.13% m/m, below our forecast and market consensus (0.17% and 0.20%, respectively). 12-month inflation decelerated to 4.66% (from 4.94% in April), and should keep plunging in June to 3.2%, according to our estimates, mostly on the effect of last year's truckers' strike dropping from the comparison base. Combined with lukewarm economic activity, we believe these factors should continue to pressure the Central Bank to cut rates. Although in our scenario the Selic rate stays at 6.5% until 2021, we acknowledge that the likelihood of a rate cut following the approval of the pension reform has significantly increased in the past few weeks. However, we do not believe the Central Bank will make a cut before the reform passes through a first vote in the Lower House, which we do not expect to happen until August. Therefore, barring any external shocks, we rule out any rate cuts in the next two Copom meetings (June 19 and July 31). The key meeting then is on September 18. We still believe that the 2020 scenario at that time will be one of inflation above the target midpoint and accelerating economic activity, which would make the Central Bank opt for more caution; we would be willing to reexamine this should either the economy looks weaker or inflation continues to surprise to the downside.

April industrial production surprised to the downside, at 0.3% m/m. Mining continues to drag the headline, contracting 9.7% m/m and 24% y/y. Manufacturing continues to expand at a slow pace, at 1.1% in three months. May data from automakers, also released this week, suggests that the sector should not contribute much to growth in the following months, as inventories keep mounting and are at the highest level since October 2015. Sales to the domestic market are still in good shape (growing at 12.6% in the 12m/12m comparison), but exports are collapsing 35% in the same comparison.

Upcoming Data: Final April Data

Final releases on April economic activity will be out next week. We expect core retail sales to have contracted 0.1% in the month, corresponding to a 1.2% y/y rise. Headline retail sales, which include auto vehicles and construction material, should have a better performance, contracting 0.1% in the month and growing 2.8% y/y. We expect the Central Bank's monthly economic GDP tracker to post a 0.4% growth in April (-0.6% y/y), a recovery from the 0.3% contraction in March.

Political Agenda: Pension Reform Revised Draft to Be Unveiled

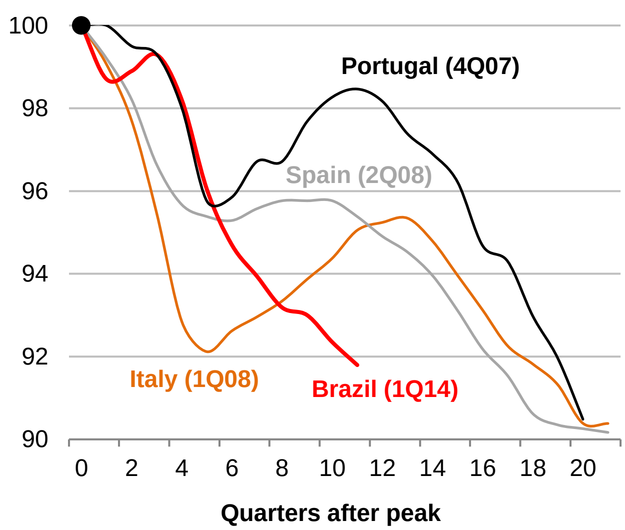
The revised draft on the pension reform proposal will be presented next week, according to the special committee's rapporteur, representative Samuel Moreira. We do expect the report to be substantially watered down from the government's initial version — total savings in 10 years should be reduced to around BRL900 billion, from BRL1.2 trillion. A pending issue is whether to include automatically states and municipalities in the reform — on June 6, 25 out of the 27 state governors signed an open letter in favor of the inclusion (later amended by another letter signed by the 9 governors of the Northeast states, suggesting changes in the draft), but the terms of an agreement with lawmakers has yet to be defined.

Following the presentation of the report, the next step a vote by the special committee. Although we do not anticipate any significant difficulties in approving the report (which requires only a simple majority in a committee appointed by party leaders mostly in favor of the reform), proceedings should, in our view, take another two weeks, as the Corpus Christi holiday on June 20 and the Saint John's festivities on June 24 usually keep Brasília relatively empty. Assuming no further delays, that would leave a narrow window — one week — to try to approve the reform in the Lower House floor before the mid-year recess. Hence, we still think a floor vote in August is the most likely scenario, as per the timeline presented in our report *The Moment of Truth: From Intentions to Bargaining* (March 28, 2019).

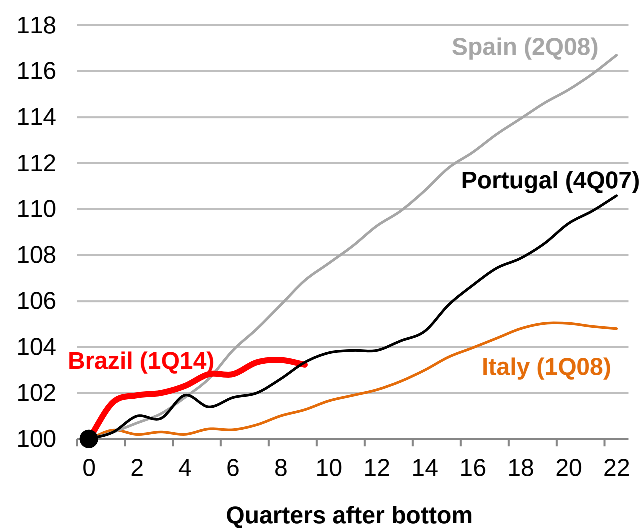
Chart of the Week: Becoming Portugal?

In 1973, during the darkest phase of Brazil's military dictatorship, beloved singer/songwriter Chico Buarque recorded his classic, *"Fado Tropical"*, whose lyrics include the verses, "Oh, this land will still fulfill its ideal/Will still become an immense Portugal." In the following year, the Carnation Revolution ousted Portugal's dictatorship and Buarque's song, despite the obvious anachronism, became the anthem of Brazil's opposition to its military regime. 36 years later, perhaps it would be a good idea if Brazil could indeed become an immense Portugal, at least as far as its GDP growth outlook goes. Our "Chart of the Week" compares the latest cycle of recession and following recovery between Brazil and three Mediterranean countries, Italy, Spain, and Portugal. The first chart shows that the recession in Brazil was shorter-lived and less deep than in the three European countries, which, curiously, ended up accumulating similar GDP losses (close to 10%) after 20 quarters following distinct paths. The second chart traces the recovery of the four countries. Following a stronger start due to the 2017's record crop, Brazil decelerated and is now, 10 quarters after the bottom, at the same point Portugal was after the same period after its GDP bottomed out (Spain went through a more linear and faster acceleration, whereas Italy is still experiencing a slow recovery followed by stagnation). After fourteen quarters of the end of the recession, Portugal's growth accelerated to an average annualized pace of 2.5% -- a performance that we expect Brazil to emulate after the approval of the pension reform, in 2H19. If our forecast is right, Brazil can be compared to an immense Portugal in a more timely fashion — after the release of *"Fado Tropical"*, Brazilians still had to endure another 11 years of military dictatorship until the resumption of democracy in 1984.

Quarterly GDP Index (Peak = 100)



Quarterly GDP Index (Bottom = 100)



Sources: Bloomberg, Santander.

Number of the Week

509k

Brazil exported 509,000 auto vehicles in the 12 months to May, the lowest figure for the period since October 2016. More in "What's New" on the first page of this report.

Quote of the Week

"*The president has no sense of priority and of what is important to the country.*"

— **Representative Marcelo Ramos,** chair of the pension reform special committee at the Lower House, on Twitter (June 4, 2019).

What We've Been Reading

- "Brazil Central Bank Is Rising Above Political Turmoil—For Now," by Mario Sergio Lima and Samy Adghirni (*Bloomberg*, June 6, 2019). Fighting for its long pursued formal independence will be a fight for BCB to pick later this year.
- "The Bolsonaros Try to Behave (Kind of. For Now.)," by Brian Winter (*Americas Quarterly*, June 3, 2019). The president seems to have moderated recently, boosting confidence that the economic reform agenda will be successful.
- "As Populists Rise, Latin America's Economies Will Fall," by Kenneth Rogoff (*Project Syndicate*, June 5, 2019). Rogoff is pessimistic with populism threatening the three largest economies in the region.

Recent Publications (Available on Our Website)

- *Is It Time to Upgrade Core Inflation Measures?* (May 21, 2019)
- *Inflation—Year of the Pig: Good Fortune?* (April 30, 2019)
- *Economic Activity: No News Is Bad News* (April 22, 2019)
- *Will Credit Be Enough to Revive Consumption?* (April 1, 2019)
- *Monetary Policy: Low for (Much) Longer* (March 29, 2019)

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