Santander
Corporate & Investment Banking

ECONOMICS

July 5, 2019

Brazil Macro Compass

Scenario Update – A New Race to the Bottom: Slower Growth, Lower Inflation, Lower Rates

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

In-Depth Research: Scenario Update

In our most recent quarterly report (*Strictly Macro*, July 1, 2019), we updated our macro scenario according to recent market developments. Based on disappointing 1Q19 and (so far) 2Q19 economic activity data, we revised our 2019 GDP growth forecast to 0.8% (from 1.3%). We also changed our 2020 growth outlook, downgrading our estimate to 2.0% (from 3.0%) – slower than expected job creation will, in our view, keep private consumption, the most important growth driver, relatively subdued. Slower growth leads to a more persistent negative output gap, which, in our view, will continue anchoring core inflation. With that in mind, and also because of the effect of an expected stronger BRL (we revised our 2019 and 2020 year-end BRL/USD forecasts to 3.90 and 4.10, from 4.00 and 4.30, respectively, due to a more supportive global background with respect to emerging market risk), we reduced our 2019 and 2020 inflation estimates to 3.9% and 4.1%, respectively (from 4.1% and 4.5%). We still see 2020 inflation above consensus, with the supply dislocations caused by the African swine fever in Asia adding around 40 bps to our forecast.

The combination of falling global rates, slower growth, and stronger currency will, in our view, allow the Central Bank to go deeper into loosening monetary policy. We now expect Copom to cut the base rate by 100 bps by the end of this year (25 bps in July, 50 bps in September, and the remainder in October) and to stay on hold throughout 2020 with the lowest Selic rate on record (5.5%). We see rate hikes only in 2021, when, according to our estimates, the output gap will be close to zero.

Political Agenda: Pension Reform on Track for Lower House Floor Vote

The Lower House special committee on pension reform concluded its work with a vote on July 4, with representative Samuel Moreira's report approved by a wide margin (36-13). Only a handful of left-of-center parties opposed the draft, with no defections from parties linked to the government and centrists. This, in our view, is evidence of a broader interparty agreement to put reform on a fast track to approval on the Lower House floor over the next couple of weeks, before the beginning of the mid-year recess on July 18. Therefore, we acknowledge that the balance of probabilities is now tipping to early approval, contrary to what we have been reiterating since February. Although there are still substantial risks of a delay, we believe the Lower House is likely to at least conclude a first vote on the core text, which, in our view, will be a sufficient condition for the Central Bank to tick the "evolution of reforms" box and start a residual easing cycle at its July 31 meeting (see "In-Depth Research" above). The voting process is expected to start on July 9 or 10 and almost entirely fill next week's legislative schedule. We maintain our estimate of BRL760 billion in savings in 10 years, net of the tax increases included in the approved report (for more details, see our report *Climbing the Cliffs in Bad Weather*, June 18, 2019).

Upcoming Data: June Inflation, May Economic Activity Data

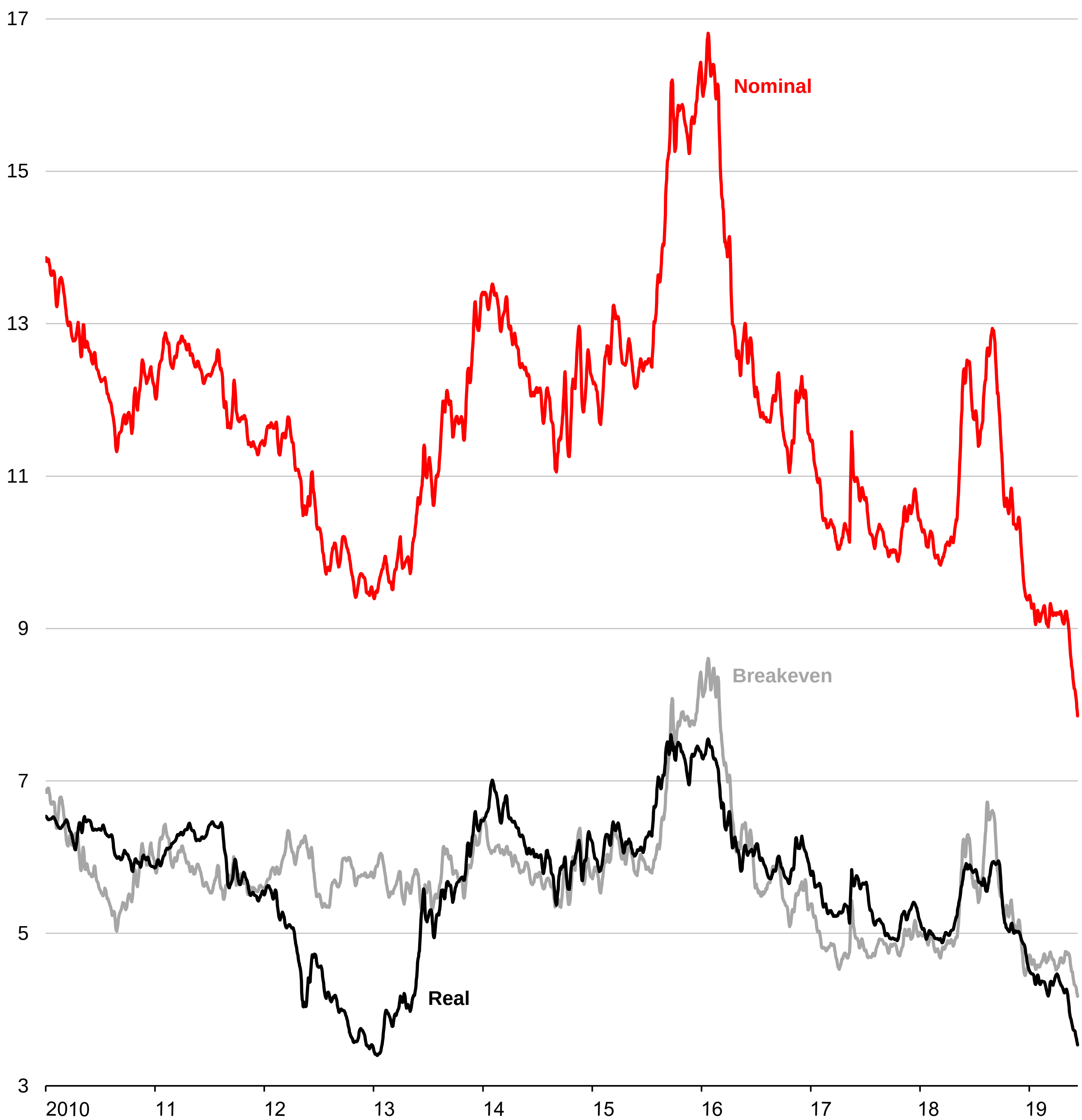
The June CPI inflation release will be out next week. We expect -0.02% m/m, with the year-over-year comparison plunging to 3.34% (from 4.66%), mostly due to the exclusion of the one-off effects of the 2018 truckers' strike. Food prices should remain in a seasonal deflationary cycle, in our view, whereas services inflation should rise from May owing to higher prices for airline tickets.

On the economic activity front, the main releases next week are the May figures for retail sales and volume of services. We expect headline retail sales at +1.8% m/m, bouncing back from a weak April print. We project that the services indicator should post a 0.3% increase in the same period, pointing toward a slow start to 2Q19, compatible with our newly revised weaker GDP growth estimate for the full year (+0.8%).

Chart of the Week: Rates at New Lows

Euphoria amid progress on the pension reform process led Brazilian domestic rate markets to fresh multi-year lows this past week. Our "Chart of the Week" follows the evolution of benchmark ten-year bond rates over the past ten years. Nominal rates clearly broke through previous lows, now trading south of 8% for the first time in the period. Breaking down that rate into a real and a breakeven inflation component, we see that real rates are matching 2012-13 lows, but breakeven inflation broke through the 4.5-5.0% range, possibly indicating a Central Bank regaining credibility regarding its capacity to meet falling inflation targets in the coming years.

Brazil Ten-Year Local Bond Rates, Five-Day Moving Averages (%)



Sources: Anbima, Santander.

Number of the Week

36

The report on pension reform was approved with 36 (out of 49) votes in the Lower House special committee.

Quote of the Week

"*I respect all the institutions, but above them is the people, my boss, to whom I owe allegiance.*"

— **President Jair Bolsonaro,** on Twitter (June 30, 2019).

What We've Been Reading

- "Democracy Bedevils Brazil's President Bolsonaro," by Mac Margolis (*Bloomberg Opinion*, July 1, 2019). Six months into his term, Bolsonaro's problems derive more from his lack of concern about structural issues rather than any authoritarian impulse, argues Margolis.
- "Monetary policy frameworks in EMEs: inflation targeting, the exchange rate and financial stability" (*BIS Annual Economic Report*, June 30, 2019). Over the past two decades, emerging countries widely adopted inflation-targeting regimes, but implementation diverges substantially among countries and from textbook recommendations.
- "An Odd Bust of Bolivars in Brazil," by David Biller (*Bloomberg*, June 30, 2019). A stranger-than-fiction plot involving worthless bills, an Iraqi central bank safe box, and Rio de Janeiro criminals.

Recent Publications (Available on Our Website)

- *Fiscal Policy: Climbing the Cliffs in Bad Weather* (June 18, 2019)
- *Economic Activity and Credit: Highway to Heaven?* (June 7, 2019)
- *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)

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
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	598-1747-6805

Fixed Income Research

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
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
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