ECONOMICS **August 9, 2019**

Brazil Macro Compass

Clash of titans

Ana Paula Vescovi* and
Brazil Macroeconomics Team
anavescovi@santander.com.br
+5511 3553 8567

- **In our view, tensions derived from the trade war between China and the US are unlikely to subside in the coming months, thus menacing the constructive assessment made by the Brazilian Central Bank (BCB) about external environment.**
- **Besides confirming that there is room for additional monetary easing–conditional to further progress in the agenda of structural reforms–the minutes of the last Copom meeting introduced a debate on the components of the neutral interest rate.**
- **Both inflation and activity indicators came below the medians of market participants' expectations, which reinforces the consensus view–which we concur with–that the balance of risks for inflation in the short term should allow the Brazilian Central Bank to cut the base interest rate in September 2019.**
- **The Lower House concluded the assessment of the pension reform, which will now be taken up by the Senate. Now, representatives should focus on discussing another key structural overhaul: tax reform.**

Trade war tensions: A week after President Trump's tweet on the decision to impose further sanctions to Chinese imports from September 1 onwards, there hasn't been any signal from either the US or China pointing towards a reduction in the level of animosity between the two nations. On the back of the lack of intervention from the People's Bank of China (PBOC) in the FX market, the renminbi weakened during the week and breached the psychological threshold of CNY7.00/USD, which led the US government to accuse and officially label China of being a currency manipulator. The status may lead to further restrictions, which means the trade war between the two countries should get fiercer rather than gentler further down the road. As a result, the Brazilian Real got hit as well, which seemed to reduce doubts about the net impact of this situation on the Brazilian economy–there are those who claim that Brazil could benefit from the conflict, as it exports to both countries. More important, the situation may make it more difficult for the Brazilian monetary authority to consider that the international environment is benign for emerging markets, which may lead the BCB to reconsider its strategy for the adjustment in the base interest rate. It is important to bear in mind that the BCB's inflation simulations considered that the exchange rate would either remain stable at BRL3.75/USD or weaken from BRL3.75/USD in the end of 2019 to BRL3.80/USD in the end of next year. As the FX rate is currently hovering around BRL3.95/USD, if it remains at this level, we are likely to see an upward impact in inflation forecasts between 20 to 30 basis points in BCB's simulations. Therefore, it will be important to assess if the positive contribution of further progress in the agenda of reforms will be sufficient to offset the negative impact from a tenser international environment.

Minutes of the Copom meeting: Albeit a bit outdated due to recent developments abroad, the minutes of the last Copom meeting reinforced the general view that under circumstances prevailing on the meeting day and conditional to additional progress in the agenda of reforms, the BCB would feel comfortable with further cut(s) in the Selic target rate. However, the monetary authority surprised market participants by bringing up a discussion about the components of the neutral interest rate. According to the BCB, the neutral interest rate comprises risk premium and risk-free neutral interest rate factors, which does not necessarily move in the same direction at all times. Apparently, Copom members' intention was to signal that further monetary policy moves may tend to become more intricate than before, which means the room for easing may be more limited than market participants thought previously.

Inflation and activity indicators: The IPCA for July 2019 registered a 0.19% MoM change, which was below both our forecast (0.23%) and the market's median estimate (0.24%), and led the inflation rate in YoY terms to recede to 3.2%

from 3.4% in the previous reading. Prices of edible items and personal items were the highlights and reinforced our view that inflation dynamics continue to be quite favorable, which should lead the IPCA annual change to end 2019 below the targeted level (3.8% versus 4.25%). The benign behavior of inflation has chiefly to do with the lethargic performance of economic activity, which we don't expect to change anytime soon. Hence inflation forecasts for the coming years should remain anchored at the goals set by the National Monetary Council (4.0%, 3.75% and 3.50% for 2020, 2021 and 2022, respectively).

Incidentally, activity indicators released in the last few days underpinned our assessment. First, we had the survey on retail sales for June 2019, which remained unchanged as compared with the previous month in seasonally adjusted terms. As a result, the sector registered a 1.2% QoQ seasonally adjusted expansion in 2Q19, especially on the back of strong vehicle sales. All in all, these numbers seemingly corroborate our perception that private consumption should increase in a very gradual fashion this year.

Then, the survey on the performance of services other than retailers showed a substantial 1.0% MoM seasonally adjusted drop in the same period (-3.7% YoY), which frustrated the market's expectation (the median market estimate pointed towards a 2.2% YoY decrease). There was no exception as far as segments that compose the survey are concerned, with IT and Transportation being the highlights (-2.6% and -1.0%, respectively in MoM seasonally adjusted terms). Adding to this update, industrial figures released in the previous week, our simulation points towards an expansion of 0.1% MoM seasonally adjusted for the IBC-BR–the proxy created by the BCB to mimic the behavior of GDP on a monthly basis that will be released on August 12. If our forecast proves right, the IBC-BR will have fallen 0.4% QoQ seasonally adjusted, which hints at a modest performance of GDP in the period (0.1% QoQ sa). For the year as a whole, we expect the effect of progress in the agenda of reforms and better credit conditions derived from lower interest rates to stoke up the economy, but the more intricate international environment should limit that recovery, which make us comfortable with our 0.8% full-year forecast.

Agenda of reforms: On the back of the conclusion of pension reform in the Lower House, representatives should now turn their eyes to the tax reform bill that is already under analysis of the Special Commission of the House–the venue where modifications to original proposals are made. However, given that there is another bill in the Senate addressing the same theme and the government wants to send a third alternative, the big question is which one will prevail. This doubt should remain for some weeks and is a good example of the difficulties that this reform could face. As for the pension reform, it is time for the Senate to start assessing it. We don't expect them to change it substantially, which means it may go through a 'fast track' process and to be concluded by the end of September.

Number of the Week

7.00 The breaching of this psychological threshold aggravated trade war tensions.

Quote of the Week

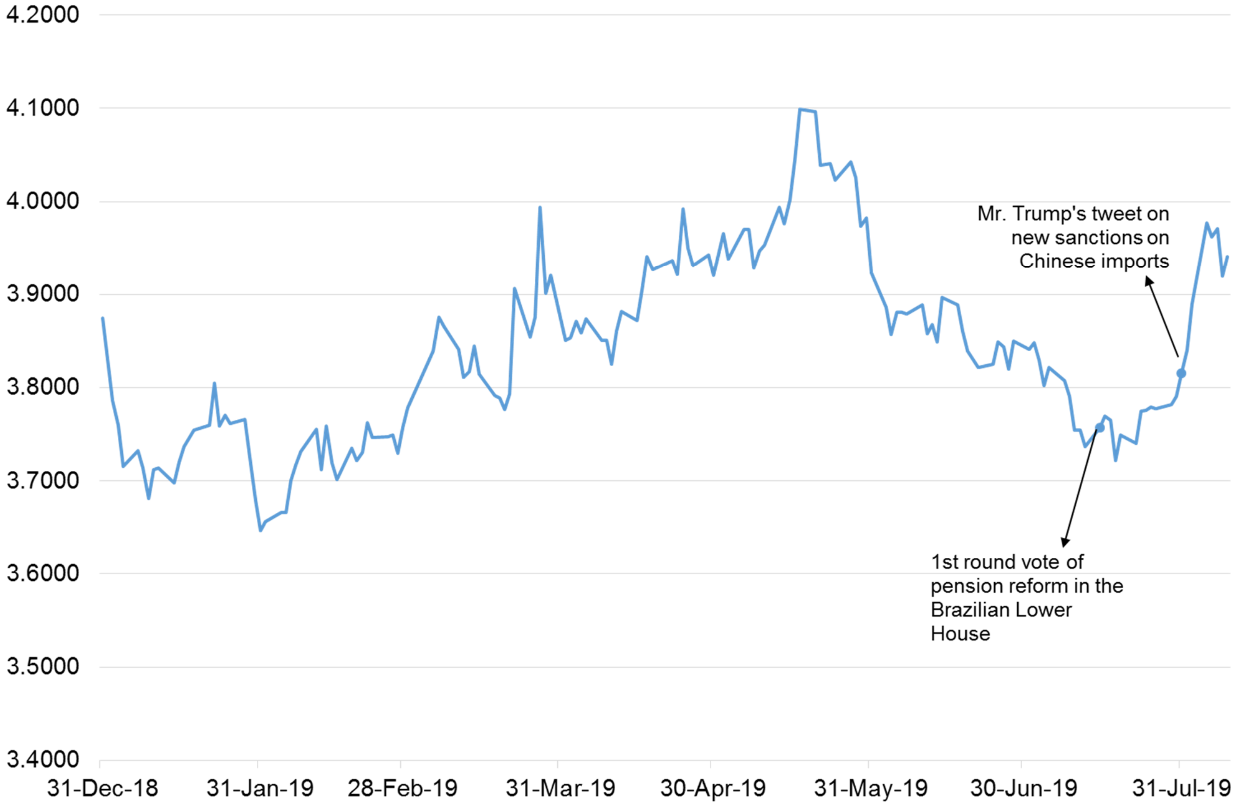
"*The best possible expectation.*"

— **Paulo Guedes**, Economy minister, asked last Wednesday about what he expects for the pension reform in the Senate.

Chart of the Week: The problem is abroad

Our “Chart of the Week” takes a look at the behavior of the Brazilian FX rate during this year and we highlight two important moments: the first round vote of pension reform in the Lower House and Mr. Trump’s tweet a week ago. While domestic factors have favored an appreciation of the BRL, external factors have led to depreciation. It will be important to move on with more progress on the domestic side, if the country wants to get a stronger insulation from other countries’ problems.

BRL – year to date



Source: Bloomberg, Santander.

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
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
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: Ana Paula Vescovi*.

*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