ECONOMICS

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Brazil Macro Compass

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Where's the Inflation?

- **Both activity indicators and inflation readings surprised market participants—and us—to the downside, thus adding evidence to the picture of a gradual economic recovery without any substantial (demand-led) pressure on prices.**
- **Surveys on retail sales and the services sector fell short of market consensus and curbed the enthusiasm brought by industrial production figures. Accordingly, the IBC-BR –Brazilian Central Bank's activity index – registered a small increase in August 2019.**
- **Regarding inflation dynamics, the IPCA surprised at -0.04% MoM in the last month (+2.9% YoY) – far below the targets set for the coming years. In addition to this comfortable environment, there were methodological changes that we expect to trim some 20bps of 2020 inflation, which supports the argument for further interest rate cuts.**
- **On the political front, senators and representatives reached an agreement regarding the sharing of proceeds from the upcoming transfer of oil rights auction, which in addition to ensuring that the auction will take place on November 6, will also pave the way for a final agreement on pension reform, in our view.**

Economic activity: Two important indicators were released in recent days: retail sales and services revenues for August 2019. Core sales managed to record a 1.3% YoY change, which translated into a paltry expansion of 0.1% in MoM seasonally-adjusted terms; the supermarkets segment—which accounts for 45% of the index—was the main driver. However, sales of durable and semi-durable goods grew less than we expected, thus confirming that the nature of the economic recovery remains gradual. The broad retail sales index—which includes building materials stores and autos and autopart dealers—was disappointing, remaining unchanged in seasonally-adjusted terms, while we were projecting it to have expanded 1.0% MoM s.a. Whereas autos and autopart dealers saw their sales receding 1.7% MoM s.a. (+2.9% YoY), building materials stores registered a decline of 0.8% MoM s.a. (-1.6% YoY). Likewise, the survey on services—the so-called PMS—was up 0.2% MoM s.a. with three of the five categories showing contractions in the same terms. The negative highlight was services for households, which dropped 1.7% MoM s.a.

Accordingly, the IBC-BR—the index built by the BCB to mimic the behavior of the GDP on a monthly basis— grew 0.1% MoM s.a. in August. We expect 3Q19 GDP to see a 0.3% QoQ s.a. expansion, which is in line with our full-year 2019 forecast of 0.8%.

Inflation: Recent developments have led us to revise downward our forecasts for 2019 and 2020: (i) September IPCA was down 0.04% MoM (+2.89% YoY). The reading was below our estimate of +0.03% MoM due to deflation in foodstuff prices, which led us to trim our projection for 2019 IPCA to 3.4% from 3.5%–a level far lower than the target set for this year (4.25%). (ii) The behavior of prices of items more sensitive to economic cycles—namely the core of services prices—has also depicted a very comfortable situation for price dynamics in Brazil. (iii) The IBGE has released a new weighting structure for the IPCA that will be used in 2020 based on its most recent survey for the household consumption basket—the so-called *POF* (Portuguese acronym)—conducted in 2017-2018. The new weighting structure sets Transportation as the main expense for Brazilians (21% versus 18% previously), with Foodstuff & Beverage (19% versus 25% previously) losing its prominence. The new weighting structure prompted us to lower our CPI forecasts for 2020. According to our simulations, we are likely to see a deflationary impact of around 20bps on next year's inflation readings, so we now expect the IPCA at 3.3% YoY in 2020 (vs. 3.5% previously). That level is also well below the target for 2020

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(4.0%), which is currently the focus for the Brazilian monetary authority. Hence, given this favorable inflation scenario, we continue to expect the BCB to cut the policy interest rate at the Copom meetings in October and December, taking the Selic rate to its historical low of 4.50% p.a. until the end of the year. We look for no further change in interest rates until early 2021.

Politics: After weeks of stalemate, the Lower House and the Senate have finally reached an agreement regarding the proceeds of the upcoming transfer of oil rights auction. There will be a 50/50 split between municipalities and states of 30% of the cash collected in the auction deducted from the compensation to Petrobras. Moreover, the amount directed to states will be distributed according to rules that appeased both northern and southern states, thus reducing the political tension of recent days. The end of the standoff also paves the way for the Senate to reach an agreement on pension reform by the end of this month.

Number of the Week

-20bps

The estimated impact on IPCA readings in 2020 from the new survey for the household basket of consumption, which will be used by the IBGE to gauge consumer price changes.

Quote of the Week

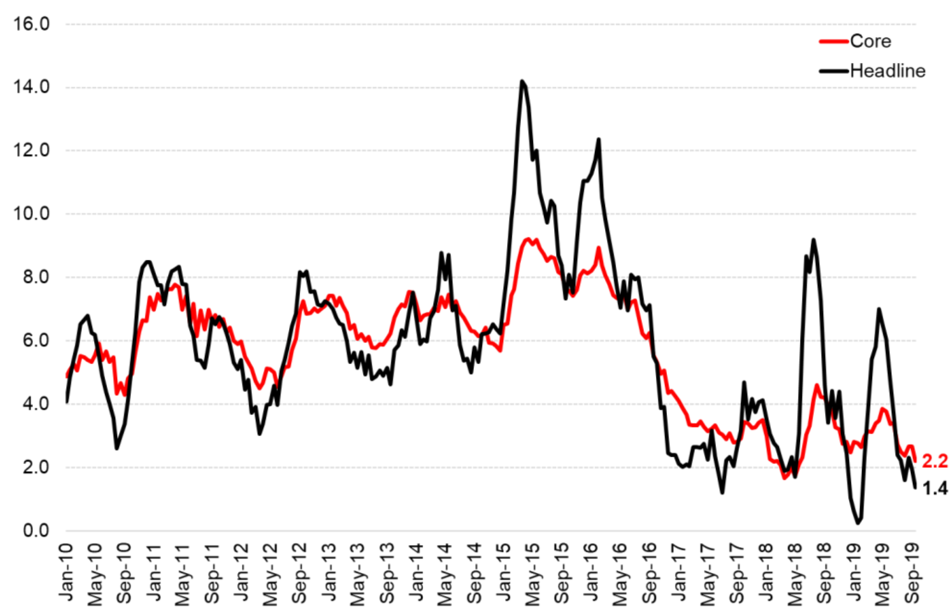
"Forget the PSL."

— **Jair Bolsonaro**, Brazilian president, asking a supporter to reject his own party, which created concerns among his coalition.

Chart of the Week: Going Down

Our "Chart of the Week" demonstrates the country's favorable inflationary environment, as in addition to headline readings currently below the targeted level, the underlying inflation measures signal that price dynamics should continue to foster low inflation figures. Consequently, market participants are becoming increasingly confident that there will likely be room for further easing of the monetary grip. We maintain our call that the Selic target rate should reach 4.5% p.a. by the end of the year and remain at that level until the end of 2020.

IPCA core – 3-month moving average annualized rate, seasonally-adjusted



Sources: Banco Central do Brasil, IBGE, Santander.

Recent Publications (Available on Our Website)

- *In Search of Growth* (August 29, 2019)
- *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)

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