ECONOMICS **January 10, 2020**

Brazil Macro Compass

Temporary Drivers of Inflation and Activity

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- **November industrial production surprised the market to the downside and reminded us all that the recovery of Brazilian industry (and the broad economy) remains gradual. We expect next week's report on retail sales to show solid results, but that is partially explained by the temporary stimulus for consumers following the release of funds from FGTS (mandatory savings) accounts.**
- **While acknowledging that 4Q19 GDP growth may not have been as strong as previously thought, we continue to anticipate consistent improvement in domestic economic activity in the coming quarters.**
- **IPCA – Brazil's official inflation gauge – showed a significant increase in December, strongly influenced by supply shocks affecting food and fuel prices. Accordingly, 2019 inflation was slightly above the central bank's *midpoint* target (4.31% vs 4.25%). Yet the current data continue to signal a lack of demand-led price pressures, and we maintain our scenario of a well-behaved path for inflation over the coming quarters, amid still high spare capacity in domestic activity and well-anchored expectations.**
- **All in all, we believe this week's economic data continue to imply the likelihood of some moderate addition of monetary stimulus in 1Q20. Our scenario projects a terminal Selic rate of 4.00% for this cycle (after a couple of additional cuts of 25 bps each in February and March).**

Economic activity: November industrial production frustrated expectations. According to the Monthly Industrial Survey released on Thursday (January 9), industrial production fell 1.2% m/m (-1.7% y/y) in that month, considerably below market expectations. Regarding the main industrial categories, intermediate goods – which account for nearly 60% of overall industrial production – registered the most disappointing result (-1.5% m/m), mostly due to the poor performance of mining output. These frustrating figures for November, along with the significant decline in vehicle production in December (-4.0% m/m) – published on Tuesday (January 7) – led us to revise our forecast for industrial production growth in 4Q19 (to 0.4%, down from 1.2%).

Moreover, November data for retail sales, services revenue, and IBC-Br (the Brazilian Central Bank's activity index, a proxy for the official quarterly GDP on a monthly basis) will hit the wires next week. First, we expect the retail sector to show strong monthly growth, owing to the temporary income increase from the release of FGTS (mandatory savings fund) resources. Our estimates are 1.4% m/m growth for core retail sales and 0.9% growth for broad retail sales, which include building materials sales and autos and auto part dealers. Regarding the services sector, however, we forecast a slight decline of 0.2% m/m, since we expect services categories linked to manufacturing output to record a weak performance. Accordingly, we forecast that November IBC-Br will show paltry growth of 0.1% m/m (1.0% y/y).

Although we remain positive regarding the performance of economic activity in 4Q19, we recognize that, in light of the recent industrial data, GDP growth may not have been as strong as previously thought. Therefore, we assign a downward bias to our current forecast of a 0.8% q/q expansion for 4Q19 GDP (official results will be published on March 4), which is in line with a full year 2019 expectation of 1.2%.

Inflation: IPCA (Brazil's official inflation index) posted a strong increase of 1.15% m/m in December, leading full year 2019 inflation to 4.31%, thus slightly above the targeted level of 4.25%. December's IPCA spike (relative to December's IPCA preview: +1.05% m/m) was driven by: (i) the shock in animal protein prices (beef, chicken, etc.), contributing 59 bps to the headline; (ii) the rise in fuel prices, whose contribution was about 20 bps; and (iii) a gambling price readjustment in November, contributing 7 bps. We note that IPCA would have registered a 0.29% m/m gain were it not for these temporary factors, still signaling a benign inflation backdrop.

IPCA-EX3 (the most sensitive core inflation gauge of monetary cycles) rose 0.49% m/m, higher than the 0.34% variation recorded in the mid-month preview, especially due to hikes in prices of edible items and personal hygiene. Were it not for the aforementioned temporary shocks, IPCA-EX3 would have remained virtually stable in December. According to our own calculations, the seasonally adjusted result (of the IPCA-EX3) stood at 0.31% m/m in December compared with 0.28% in November. In 4Q19, this important gauge of demand-sensitive prices posted an annualized pace of 3.3%, below the midpoint target for 2020 (4.0%). For 1Q20, we anticipate a smaller impact from the shock in animal protein prices and much lower headline inflation (c.0.3-0.4% per month), reinforcing our assessment of a well-behaved path for inflation, due to the still high spare capacity in domestic economic activity and anchored inflation expectations.

Recent Publications (Available on Our Website)

- *Macroeconomic Scenario: A Better Outlook* (December 13, 2019)
- *Macroeconomic Scenario: Better Days Ahead* (October 31, 2019)
- *Brazil Economic Activity: In Search of Growth* (August 29, 2019)
- *Brazil Fiscal Policy: Climbing the Cliffs In Bad Weather* (June 18, 2019)

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