ECONOMICS

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Brazil Macro Compass

End of Story

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

- **Both here and abroad, the week of February 3-7 was marked by a continuous strengthening of the USD in addition to new signs of disinflation and weak activity.**
- **After announcing another cut in the Selic policy rate (to 4.25% p.a., a historical low), we believe the Copom indicated the end of the easing cycle.**
- **Latest releases about activity indicators have unveiled weaker-than-estimated outcomes. Hence, although we stick to our scenario of a (gradual) recovery of the domestic demand, we assign a downward bias to our GDP growth forecasts for 2019 and 2020.**
- **January inflation printed a 0.21% MoM change, which was below market expectation and ours as well (Santander: + 0.33%, Bloomberg median estimate: + 0.36%). With this result, inflation is at 4.19% YoY—a level above the Central Bank's 2020 target (4.00%).**
- **Despite the negative surprise with the trade deficit last January—due to *ad hoc* factors—foreign trade dynamics are likely, in our view, to remain compatible with our expectation of a marginal retreat in the trade surplus in 2020.**

Externally, markets remain focused on the adverse effects on economic activity and raw material costs of the coronavirus outbreak in China. The impact of this shock on the world's second largest economy (and Brazil's largest trading partner) contributed to a recent weakening of commodity currencies, such as the Brazilian real (BRL). The latter fell slightly less than 1% to the USD this week, taking the FX rate to the highest nominal level in the series (north of 4.31). The global strengthening of the USD and low interest rates in Brazil also contribute to the depreciation of the exchange rate, increasing the risks for our year-end forecast (currently at 4.00).

In Brazil, after announcing another cut in the Selic policy rate (to 4.25% p.a., a new historical low), we believe the Copom indicated the end of the easing cycle; additionally, the result of January IPCA surprised to the downside and showed a benign underlying composition. It is possible that these factors (i.e., end of stimuli and an absence of demand-led inflation) contributed to another bull-flattening of the local yield curve. In fact, with activity numbers pointing to an even slower-than-expected recovery, downside risks are rising for our year-end 2021 Selic rate projection (currently at 6.00%). As an upshot, we see room for some further flattening of the yield curve ahead.

Monetary policy: For a fifth meeting, the Copom—Monetary Policy Committee of the Brazilian Central Bank (BCB)—decided to lower the policy rate. This time the cut was less sharp than the previous four occasions, with today's 25-bp move taking the Selic rate to 4.25% p.a.—a new record low. This result was widely expected by market analysts and priced in by the yield curve.

In the statement, the only (slight) surprise was the fact that the Copom (pre-) announced the interruption of the easing cycle, which totaled 225 bps since July 2019. Justifying this announcement, the authority cites mainly the lagged effects of the stimuli already implemented. The Copom also reaffirms that " its next steps will continue to depend on the evolution of economic activity, the balance of risks, and inflation projections and expectations", but highlight the "increasing weight for 2021", as a monetary policy horizon.

This last factor is particularly relevant for the decision, given that the simulations for IPCA inflation presented in the communiqué point to estimates dead in line with next year's central inflation target (3.75%). In fact, in a scenario

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assuming a stable Selic rate all the way at 4.50%, the BCB simulation points to IPCA of 3.5% this year and 3.8% next year. For a scenario assuming Selic rate of 4.25% at year-end 2020 and 6.00% at year-end 2021, the Central Bank estimates inflation of 3.5% for 2020 (mid-target: 4.00%) and 3.7% for 2021. All these scenarios assume a stable exchange rate (USD/BRL) at 4.25 for the entire horizon.

Another motivation possibly supporting the BCB's decision to indicate the end of the cycle in advance deals with the possibility of a stronger-than-expected economic activity reaction to the stimulus already implemented. In the paragraph where the Copom discusses the balance of risks, the Committee highlights the (upside) inflationary risks from an eventual increase in the power of monetary policy, “due to the changes in credit and capital markets”. The idea here is that, given ongoing structural changes in economic policy, in particular in government participation in broad activity and in the credit market, the transmission mechanisms of a lower interest rate to activity can act even more intensely than expected and prompt a surprisingly fast economic momentum, possibly weighing on the inflation outlook.

As for the scenario assessment by Copom, there were few significant changes. The BCB reaffirms expectations of a continued process of a gradual economic recovery. With respect to the international scenario—for now, with the authority making no explicit mention to the disinflationary risks (of uncertain length and magnitude) generated by the coronavirus —the expansionary monetary policy stance in advanced economies is still seen as a major factor behind a “relatively favorable environment for emerging economies”. In the realm of inflation, despite what was (in our view, only temporarily) “less disinflationary” data on underlying inflation as per the IPCA preview for January, the Central Bank sees inflation cores still “running at levels compatible with meeting the inflation target at the relevant horizon for monetary policy”. We completely endorse this view.

In short, the BCB's communication was quite clear in heralding the end of the easing cycle. The focus is now on the timing and speed of an expected normalization of (what is now a considerably expansionary) monetary policy stance. In an environment as described in our baseline scenario, where the country keeps following the path of economic and fiscal reforms—contributing to the maintenance of broadly anchored inflation and economic expectations—and assuming an absence of greater shocks from abroad, the speed of local demand recovery will be the main condition for inflation to be in line with the central target set by the CMN Monetary Council for 2021. In other words, under these conditions, the shape of the economy will be the main guide for the timing and speed of withdrawal of the monetary stimulus.

Given the downside risks that we are currently identifying for GDP growth this year, within the context of a gradual recovery, we believe that a more moderate pace of monetary policy normalization can be expected next year. Currently, our scenario has rate hikes starting in 2Q21, bringing the Selic rate to 6.00% at the end of next year. This would be closer to the level of structural interest rate that we calculate—around 3% in real terms—and consistent with an erosion of economic slacks we envision for 2022. But the risk here is a possibly slower normalization.

Economic activity: Brazilian Industrial Production fell 1.2% y/y in December 2019, in line with our estimate (-0.9%) and the market consensus (-0.8%). Compared to November, the fall was 0.7% after seasonal adjustment. As a result, industrial production in the last quarter of last year grew by just 0.2% q/q (seasonally adjusted terms), and in 2019 it contracted 1.1%. Although the contraction is mainly explained by the 9.7% annual drop in the mining due to the Brumadinho dam collapse, the tepid growth of only 0.1% in the manufacturing industry in the last year explains the weak performance of the Brazilian industry in 2019. The breakdown reinforces the fragility of the industry at the end of last year, the diffusion index (percentage of industrial categories with monthly growth in December) reached 49.4%. Among the categories, we highlight the declines in the production of capital goods (-8.8% m/m) and durable goods (-2.7% m/m) reflecting the weak coincident data on the production of trucks and vehicles respectively.

Moreover, December 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 core retail sector to show paltry 0.2% monthly growth. Regarding the broad retail sales, which include building materials sales and autos and auto part dealers, we forecast a 0.7% m/m decrease especially due to the expectation of a sharp monthly fall on the vehicles sales. Although those figures does not seems promising, in our view the retail had a strong growth in the last quarter of 2019, owing to the temporary income increase from the release of FGTS (mandatory savings fund) resources. Our estimates for the core and broad retail sales growth in the 4Q19 is 1.4% q/q and 0.7% q/q respectively, implying a full year growth of 1.9% and 3.9% in 2019.

Concerning (part of) the services sector, we forecast a strong decline of 0.9% m/m, since we expect services categories linked to manufacturing output to record a weak performance. Nevertheless, once again, the temporary stimulus of the FGTS release generates a positive outlook for last quarter of 2019. Our forecast is a 1.2% q/q growth, implying a full year growth of 0.9% in 2019. Accordingly, we forecast that December IBC-Br will show tough decline of 1.0% m/m indicating a modest 0.1% q/q in the 4Q19 and 0.9% full year growth.

Even though we acknowledge that, even discounting the FGTS effect, the country's economic growth is gradually gaining momentum. The good figures of 4Q19 economic activity indicators should be worse than previously expected. Hence we recognize that 2019 and 2020 economic growth have a downward bias.

Inflation: The IPCA 0.21% MoM change in January 2020 was a bearish surprise for the market, which expected IPCA to print a MoM change above 0.30%. What we must observe here is the composition of the index and, consequently, its quality (cores and dispersion). There were bullish surprises: among the 9 groups that comprise the IPCA, only Housing showed acceleration in relation to December 2019, with housing expenses contributing +6 bps to the headline. On the other hand, we continue to see a drop in protein prices (-11 bps), and the biggest surprise came from Health and Personal Care (-4 bps), and Foodstuff (-2 bps).

Whereas the diffusion gage (i.e., number of items that recorded a price increase) ran above the average of the last 10 years, we observed a reversal of that trend in the January IPCA. With the end of the protein shock observed at the end of last year, we infer that the temporary price increases impacted the diffusion indices, and we expect them to resume their historical trajectory in the coming months.

Underlying services and cores receded substantially last month. The seasonally adjusted annualized moving average shows a return to the level of 3% of the IPCAEX-3 and 3.9% for core services. We note that this IPCA is calculated using the weighting of the new household consumption survey—dubbed POF in Portuguese—which will not generate a revision of the historical series.

Trade balance: The USD1.8 billion deficit registered in January 2019 surprised negatively both the market's median estimate (+USD0.3 billion) and our calculation (balance between exports and imports). Were it not for imports of two oil platforms that amounted to USD2.0 billion according to the Foreign Trade Secretariat, both our estimate and market median estimate would have been fairly met. Imports of oil platforms are related to changes in taxation rules related to oil sector, whose impacts should end this year. Hence, oil platforms aside, our forecast of a USD38.3 billion trade surplus in 2020 continues to seem feasible.

Whereas exports to Argentina—Brazil's third largest trading partner last month—increased by roughly 1% in y/y terms, sales of Brazilian products to China and the U.S.—Brazil's first and second trading partner last January, respectively—receded 8.8% and 28.9% in the same terms. Larger exports of manufactured goods were responsible for the expansion of product sales to Argentina, which reinforces our view that the decline observed last year in exports to that country may not be repeated. However, the overall decline observed in sales to China and the U.S. remind us that the prospects for the Brazilian trade balance continues to be of a shrinkage in its trade surplus this year. We expect the trade balance to end 2020 at USD38.3 billion from USD46.7 billion in 2019.

Recent Publications (Available on Our Website)

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- *Brazil Macro Propositions for 2020* (January 13, 2020)
- *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)

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
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
Luciano Sobral*	Senior Economist/Strategist – Brazil	lusobral@santander.com.br	5511-3012-6209
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			
Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Daniel Gewehr*	Head, Brazil	dhgewehr@santander.com.br	5511-3012-5787

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