Brazil Macro Monthly
Vaccine outlook helps, but domestic drivers are key

November 2020

xp investimentos

Brazil: Vaccine outlook helps, but domestic drivers are key

- The global economy outlook has improved with the outcome of US elections and the fast progress on the Covid-19 vaccine. But for Brazil, domestic risks are key.
- The weeks following the municipal elections (on Nov 15) will be critical for the Government to reinforce its commitment to the spending cap and to debt stability. The combination of fiscal uncertainty and high current inflation makes short term actions particularly important to anchor longer-term expectations.
- Our baseline scenario continues to be that the fiscal framework will be maintained for 2021. Our forecasts for 2021 remain: GDP growth at 3.4%, IPCA inflation at 3.6% and BRL at 4.90 reais per dollar. The Selic rate stays at 2.00% until mid-next year and rises gradually to 3.00% in December.
- This manageable scenario opens a window of opportunity next year to move forward with the emergency PEC and other reforms, which will be crucial to shield the fiscal framework in 2022, the election year.

Forecasts

	2018	2019	2020 (E)	2021 (E)
GDP growth (%)	1.3	1.1	-4.6	3.4
IPCA (CPI, 12m, %)	3.75	4.31	3.6	3.6
SELIC rate (% p.y., end of period)	6.50	4.50	2.0	3.0
FX (USDBRL, end of period)	3.87	4.03	5.20	4.90
Primary fiscal deficit (% GDP)	1.6	0.9	12.8	3.9
Gross debt (% GDP)	76.5	75.8	94.4	96.3

Source: IBGE, BCB, Bloomberg. Estimates (E): XP Investimentos.

Foreword: A Critical Moment

With US elections now (almost) behind us, the world turns back to Covid. On the one hand, the second wave spreads, increasing risks to the recovery of global output in the short term. On the other hand, improved prospects for an effective and widely available vaccine boosts confidence for 2021.

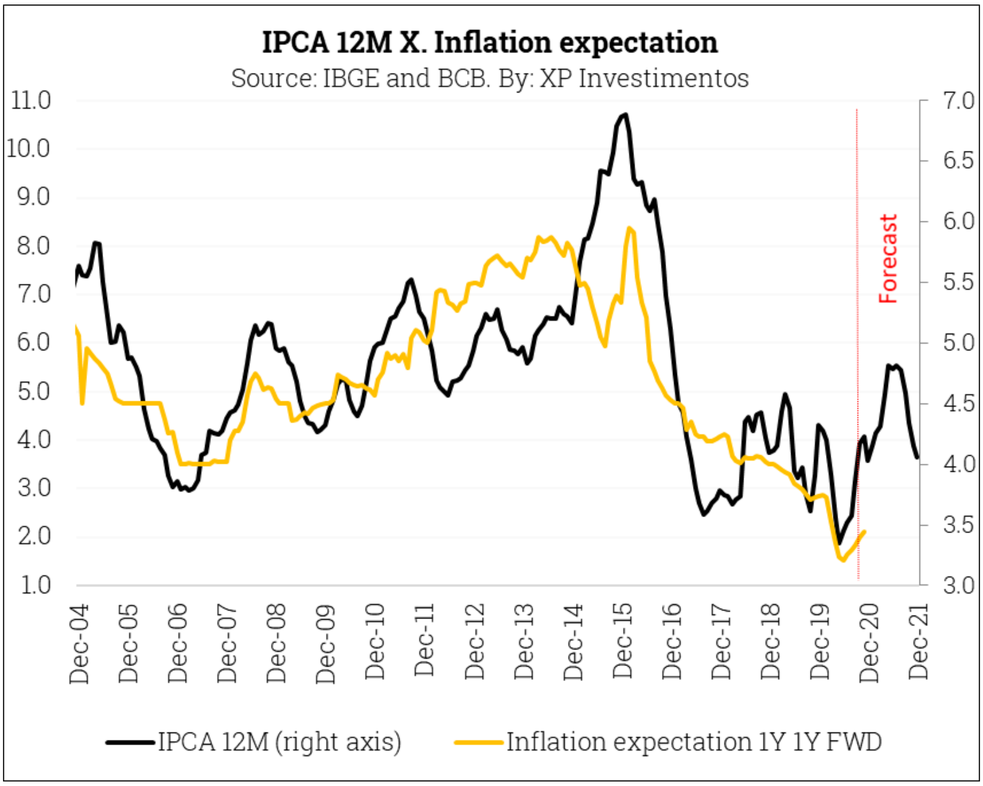
But in Brazil, domestic events will drive the scene, and fiscal accounts will be at the central stage. The discussions on the Emergency Constitutional Amendment and possible measures to expand existing cash transfer programs and/or create new ones should resume after the upcoming municipal elections (Nov 15).

Against this background, it will be crucial to keep expectations well anchored. Uncertainty over the sustainability of public accounts, allied with short-term strong inflationary pressures - IGP-DI exceeded 22% in 12 months! – calls for caution. Historically, inflation expectations, even for the long term, are correlated with current inflation (see chart). If there are no concrete signals that the measures discussed in Congress will be consistent with long-term debt sustainability, the inflation outlook may deteriorate, even with moderate growth and high unemployment in 2021.

In this sense, Central Bank may adopt a slightly more hawkish tone in coming months, and even hike rates earlier than expected if Fiscal Outlook deteriorates further.

This is not, however, our baseline scenario. Despite the noise and uncertainty, we believe the Government will not sponsor any fiscal slippage, particularly at this critical juncture. Lessons from Macri's outcome in Argentina (economic deterioration cost his re-election) and Dilma's in Brazil (creative accounting and impeachment) doubles the bet for discipline.

If confirmed, this scenario may bring a window of opportunity in the first half of next year to advance the Emergency PEC and other reforms, which may shield fiscal governance for the period leading up to the 2022 presidential elections.



The International background: Short term challenges, medium term hopes

In the **United States**, barring a miracle for the Trump campaign with its ongoing legal strategy, this presidential election is over, and the new president will be Joe Biden. We find it very positive that despite the race proving to be this tight, violence has remained virtually nonexistent. We think that President Trump has a clear exit strategy out of the current conundrum: announcing that he will run again in 2024. After all, Trump will be leaving the White House a one-term president, but also as the sitting president, up until now, who has received the most votes in history (almost 72 million). Also, of very high relevance, unless the Democratic Party has an awesome night this coming January 5th on the Georgia runoffs, the balance of power of the Senate will remain 52-48 in favor of the Republican Party.

We think that the Republican Party keeping the Senate is key for the market continuing to trade well. Yes, NO blue wave means NO massive fiscal stimulus in the forthcoming weeks. But NO blue wave also means (1) no meaningful individual or corporate tax hikes, (2) no Supreme Court-packing, (3) no moratorium on fracking, (4) no single-payer insurance system, (5) no detrimental actions against technology giants, and (6) no meaningful changes in environmental regulation standards. In other words, continued Washington gridlock will remain present if the Republican Party holds the Senate after January 5th, and we think that lingering gridlock is a positive development for the market.

We see an approved stimulus package in the next few weeks, but it will likely be smaller compared to the expectations that were present before the election (our call is that the package will be worth somewhere around USD 1 trillion). On the monetary policy front, we expect the Fed to take a wait-and-see approach, leaving the doors open for more future accommodation if needed.

Regarding the impact of new coronavirus infections, Fed Chairman Powell underscores that the intensification of the pandemic was “particularly concerning” and that it posed larger downside risks to the outlook. We think that the latest positive news on the employment front, tied with the fast progress on the vaccine front, are sources of hope that additional Covid-related measures may not be needed.

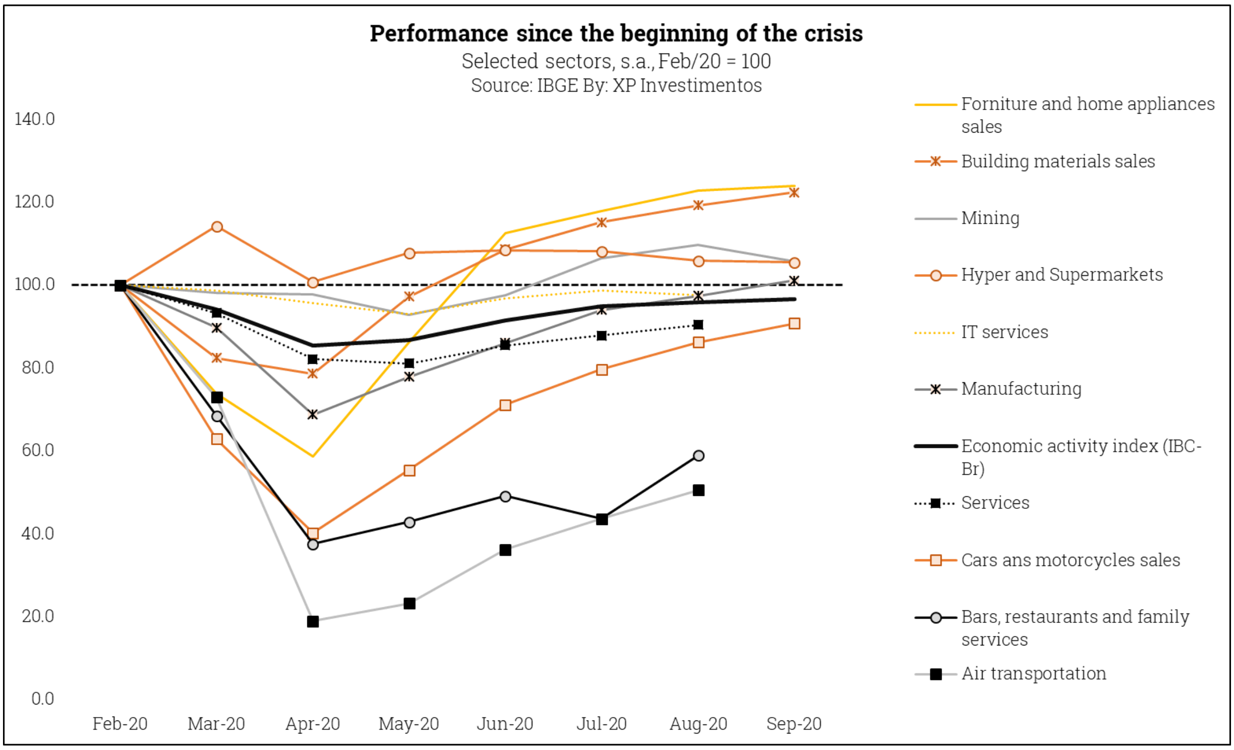
In **Europe**, we believe that the acceleration that has taken place in the spread of the virus will have clear derogatory consequences on the pace of growth of the Eurozone’s economy in 4Q20 and 1Q21 (we expect negative sequential growth in the former and weak-to-flat expansion in the latter). Such a reality is already generating pressure on the ECB to deliver additional accommodation and we expect it to announce more stimulus measures in December, once the next set of staff’s economic projections are published.

Regarding the outlook for **Emerging Markets** (EM), we continue to think that a scenario of the Senate remaining in Republican hands remains the best possible one for the EM region, as US tax policy will most likely remain stable, monetary policy should not change, and regulatory hurdles on multinational companies will likely remain stable. The availability of a very effective vaccine is also a great omen for the future performance of EM assets. Under our baseline scenario, the US Dollar should continue to weaken, clearly implying a supportive development for regional asset prices and future FX performance. Latam FX remains cheap at current levels. We are particularly bullish on the MXN, which will remain as one of the highest yielding currencies and with more room to appreciate given improving trade balance dynamics with the US, and on the COP, one of the main beneficiaries of higher oil prices.

Brazil: Vaccine outlook helps, but domestic drivers are key

Recovery to continue, with a different pace and composition

Economic output continues to recover. September data pointed to additional growth in retail (+ 0.6%) and in manufacturing (+ 2.6%). Services are also edging up, albeit at a slower pace (+1.8%), benefiting from looser Covid-related restriction rules.

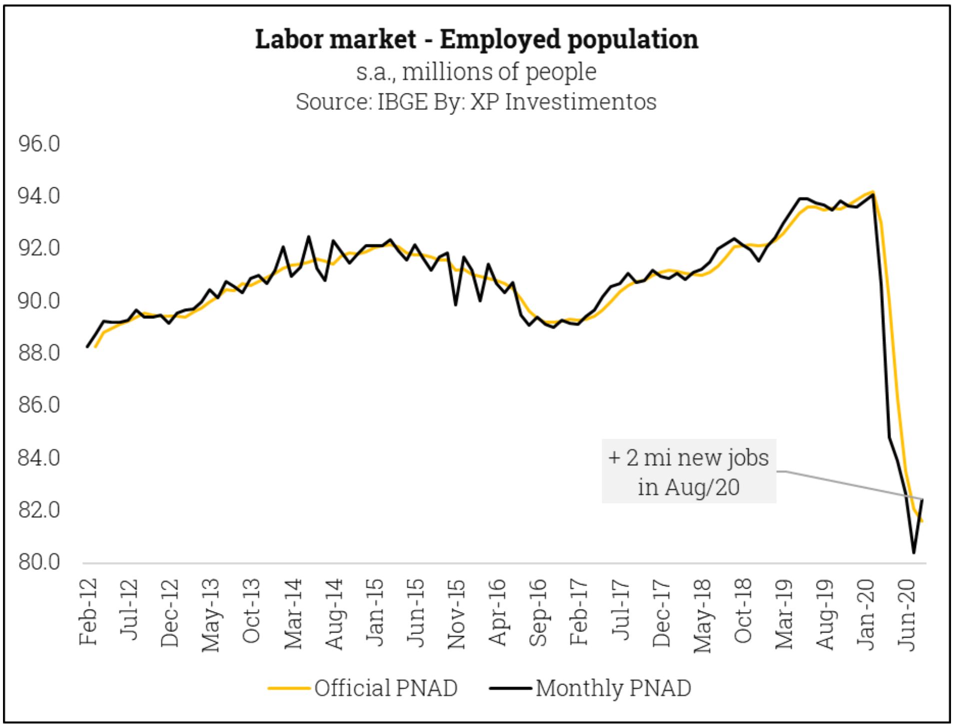


The government reduced the emergency aid to R$ 300 from R$ 600 in September. Still, we forecast third quarter GDP to have grown at a record 7.8% QoQ SA, consistent with -4.6% for the year.

In 2021, recovery should change gears, as a vaccine becomes reality and the economy returns to normal. Sectors benefited from the 2020 emergency aid, such as foodstuff, building material and durable consumption goods of lesser value are likely to lose strength. This slowdown should be partially offset by services, higher-ticket consumption goods, and other credit-related sectors. The net result is lower, but still positive, GDP growth.

We keep our 3.4% forecast for 2021, with most of this result prompted by a statistical carry-over effect (2.6%).

Nonetheless, there are risks on the horizon. The service sector, which represents about 60% of Brazilian GDP, may have its recovery halt by fresh social distancing measures as a result of a possible (though still not probable) second wave of Covid in the country. Another risk is the uncertainty of growth rebalancing. This move will be contingent on three factors: i) the pace of consumption at the end of the year; ii) the behavior of wealthier families regarding the savings built during the pandemic period; and iii) most importantly, the labor market.



We believe the labor market reached its bottom in June or July. The PNAD numbers showed some job creation in August, both in the formal and informal job markets. On the other hand, the end of Government aid programs next year should spur the labor force, keeping the unemployment rate high. We forecast unemployment to reach 16% in March (from 14.5% today), and come down gradually to 15.2% by 2021 year end.

"Covid inflation" is a risk, but tends to fade

The economy's peculiar dynamics during the Coronavirus pandemic has resulted in increased pressure on current inflation. The intense fiscal and monetary expansion, the significant rise in commodities prices (not accompanied by BRL appreciation), the recomposition of margins in the services sector with the gradual reopening, and the mismatch between supply and demand for industrial goods have translated into consumer price pressure -- a movement that may extend to the beginning of next year.

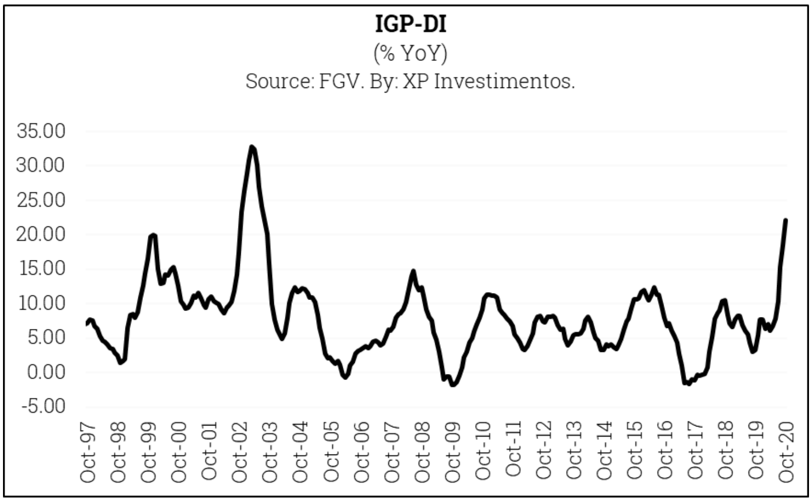
General Price Index (IGP-DI), mostly comprised of wholesale inflation, reached 22% in October (YoY), the second highest level in the post-real period. Part of this wholesale pressure is yet to reach consumer price indexes.

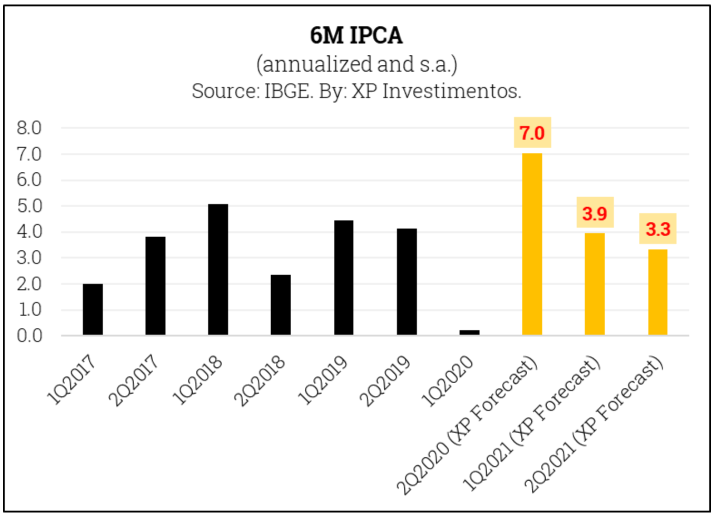
In this scenario, we revised our IPCA forecast for 2020 from 3.3% to 3.6%, and for 2021 from 2.6% to 3.6%.

Nonetheless, spare capacity (mainly in the labor market) and the withdraw of fiscal support suggest that the current inflationary shock is temporary. Indeed, our IPCA revision for 2021 was concentrated mostly in the first half of next year. For the second half, we still see the seasonally adjusted annualized IPCA at 3.6%, below the Central Bank's 3.75% target.

Thus, our 2021 IPCA forecast of 3.6% is consistent with both this year's "Covid inflation" shock and the fundamentals of the economy, which indicate well-behaved core inflation over time.

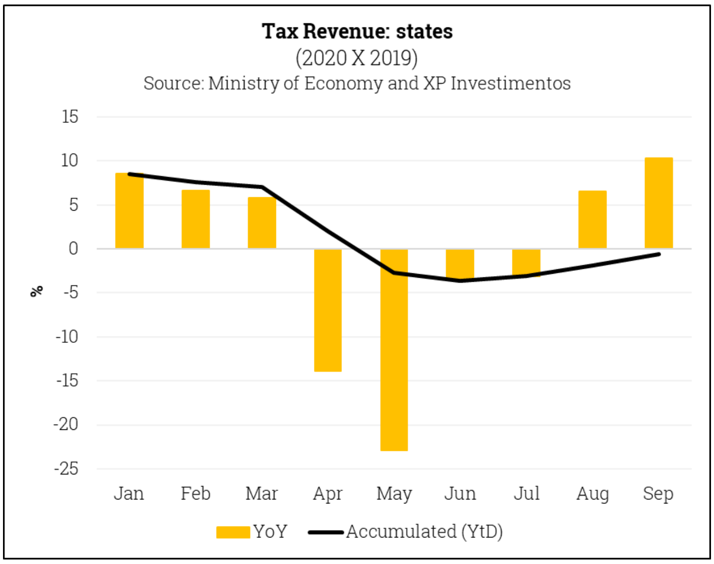
However, if the alternative scenario of diverging expectations as described in the foreword of this report, higher inflation would be more permanent.





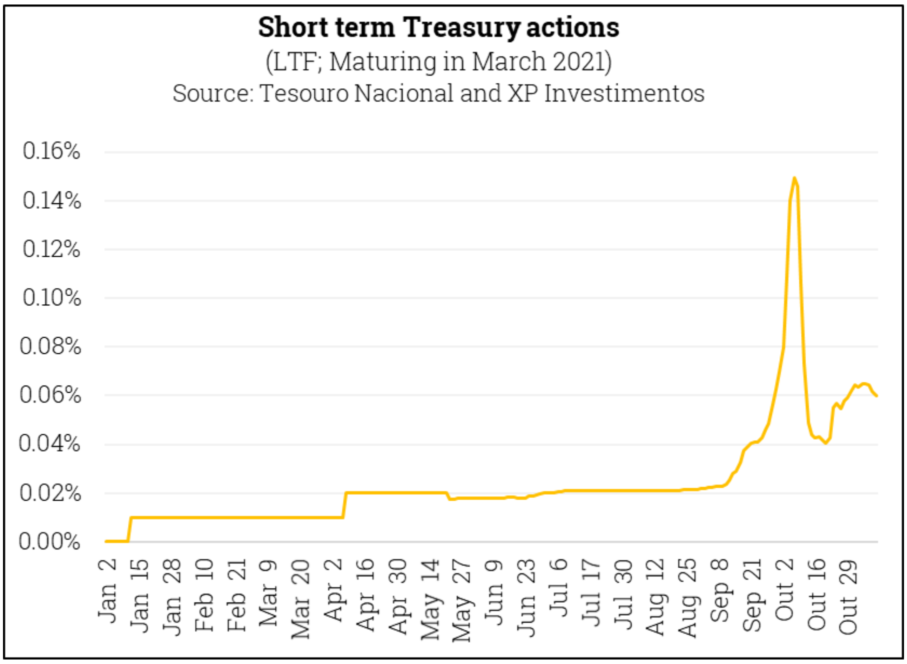
Fiscal outlook is challenging, even without new cash transfer program

September's fiscal results approach the expected scenario for year end. The general government's primary deficit reached 9.1% of GDP and gross debt-to-GDP ratio is 15 p.p. above December 2019 (at 90.6%), reinforcing concerns about fiscal sustainability in the post-pandemic period. Growing concerns are visible despite the recovery of tax collection, mainly in States and Municipalities, in the wake of the resumption of economic output in the third quarter.

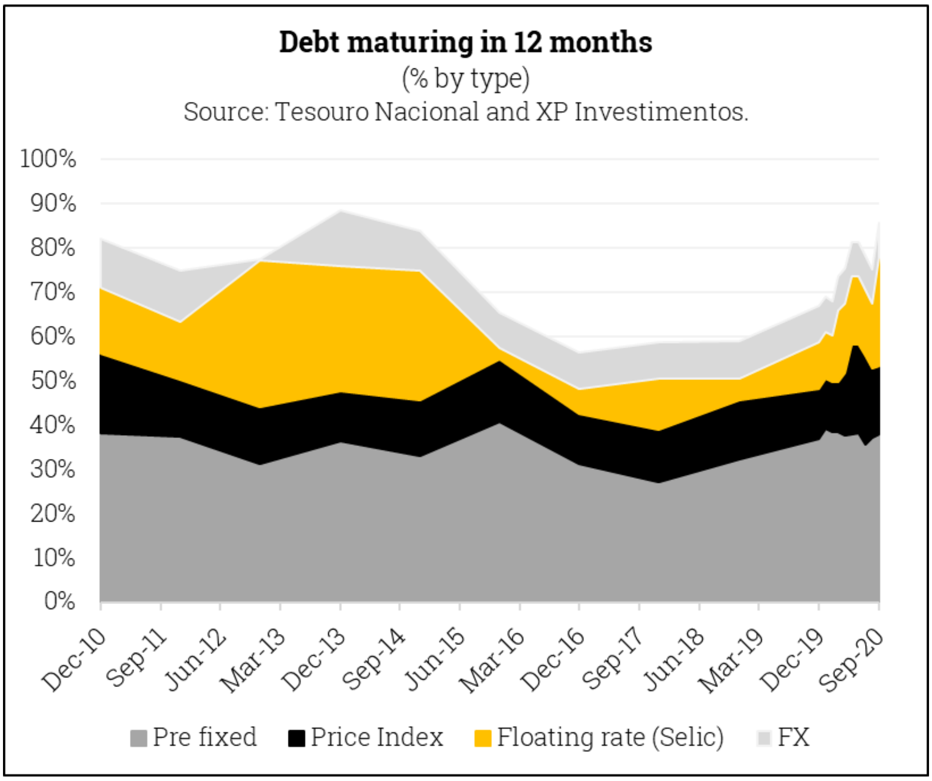


As discussions over a new cash transfer program got postponed for after the upcoming municipal elections, we saw some easing in the stress level at the public bond market. The joint initiative by the Central Bank and the National Treasury also helped. It reduced the rollover of Central Bank's repo operations (operações compromissadas) and shortened the maturity of LFTs offered, to overturn what was classified by the financial authorities as a market disequilibrium -- based on two competing government bonds with the same maturity.

Indeed, the Treasury managed to raise a total of R$ 147 billion in primary bond offers in October, at rates gradually lower throughout the month (see graphs).



Nonetheless, the worsening of the fiscal outlook imposed a substantial shortening of public debt duration, which represents an additional risk. At present, 66% of the public debt can be classified as highly sensitive to changes to the base interest rate (compounding treasuries linked to the Selic rate, repo operations, and treasuries to be renegotiated in the next 12 months). Every 1p.p. increase in the Selic rate implies an additional R$ 36.3 billion in the debt burden (considering the DBGG). This may narrow the Central Bank's room to maneuver when (and if) it has to tighten monetary policy.



Adding to the fiscal worries, meeting the spending cap in 2021 became even more challenging throughout this month, regardless of the discussions over cash transfer programs. Congress overturned Bolsonaro's veto to the extension of tax exemptions currently in place to 2021. The measure, allied to the hike seen in the inflation index which adjusts the minimum wage, the INPC, will add approximately R$ 18.7 billion to total mandatory expenditures in 2021. In turn, this additional spending will have to be carved out of the R$ 112 billion pockets of discretionary expenses included in the 2021 budget.

There are, however, important signs of resistance from the Economic team. The government's victory in Codefat (the council that runs unemployment benefits) prevented a R$ 7.3 billion increase to the 2021 budget, from the extension of unemployment insurance. Additionally, an ordinance from the Ministry of Economy, expected in the coming days, should limit the use of "unpaid expenses due the following year" (restos a pagar) exclusively to spending made based on the War Budget, avoiding the extension of expenses unrelated to the pandemic to beyond 2020.

The dynamics of public accounts remain the key risk to watch in 2021. Still, the firm stance of the Ministry of Economy, allied to the better outlook for the global economy with the advent of a vaccine for Covid-19, support our scenario that the current fiscal legal framework will remain untouched, bringing some relief in the short term. Our projections for the debt/GDP ratio stand at 94.4% for 2020 and 96.3% in 2021, following a mild improvement in view of the recovery in tax revenues and the expected result for regional governments.

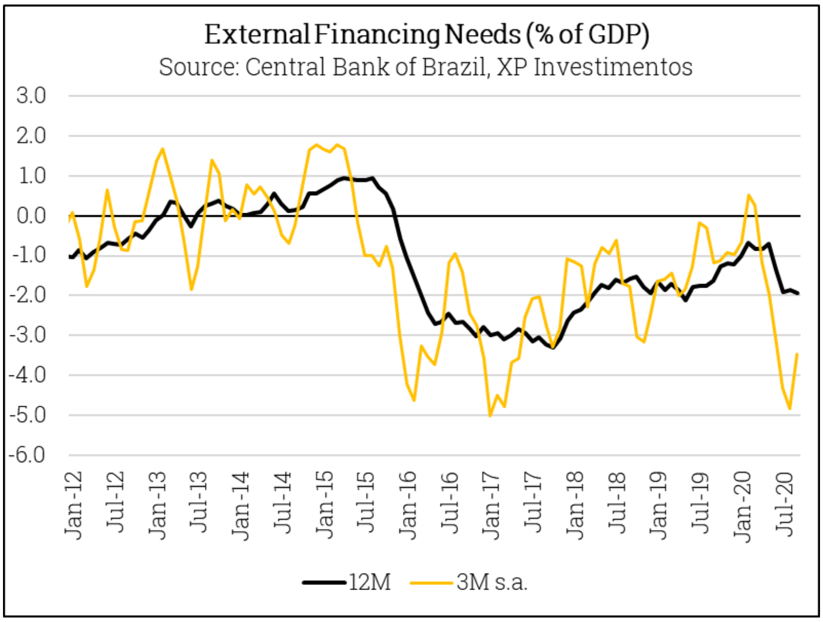
This window of opportunity should be used to move forward with legislative measures that strengthen the fiscal framework, such as the Emergency Constitutional Amendment (a summary of this and other measures can be found in Mendes, 2020). This will be crucial to shield public accounts from the 2022 election year.

External accounts point to an additional appreciation of the Real

September data reiterated the positive movement of the Brazilian balance of payments observed in recent months. The current account deficit, which ended 2019 at -2.8% of GDP, increased to an annualized 3-month average surplus of 1.7% in the month. The highlight is the trade balance, which carries an accumulated surplus of US$ 47.0 billion in the twelve months ended in September, reflecting a significant drop in imports, resilience of exports and an improvement in terms of trade.

On the financial account side, direct investments in the country continue to decline to 1.7% of GDP in the annualized 3-month average in September compared to 3,8% at the end of 2019.

The sum of the two effects (see graph) shows that the external accounts, which have been a stronghold of the Brazilian economy, remains robust.



In October, the BRL depreciated from R$ 5.60 to R$ 5.74, a movement partially explained by the approach of the election in the US, which dissipated after the event. Nonetheless, we understand that the assumptions from our last monthly report for exchange rate projections of R$ 5.20 for the end of 2020 and, with more conviction, R$ 4.90 for 2021 still hold. In particular, we understand that the current level of the real exchange rate is more devalued than its equilibrium, considering the recent behavior of the terms of trade and the dynamics of the balance of payments.

The main uncertainty, as for the rest of the scenario, lies in the perception over the sustainability of Brazil's public accounts.

A Confident Copom

Rising current inflation is not worrying the Copom. In recent official communications, the committee repeatedly stressed that the shock is temporary, mentioning the relevant output gap and well-anchored inflation expectations as the main reasons for keeping core inflation at or below the target in the relevant monetary policy horizon.

We agree. The risk for long term stabilization remains indeed on the fiscal front. We still see the Selic rate at 2.00% until mid-2021, and 3.00% at year end. This means that monetary policy will remain quite accommodative for the foreseeable future.

Still, the combination of rising current inflation and complex fiscal outlook demands additional attention by the monetary authority. We may see Copom's communication getting a tad more hawkish going forward. Given Central Bank's solid credibility, this hawkish tilt may be important to keep market confident that Brazilian macro management will remain sound in the coming year.

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