Brazil Macro Monthly

Higher Inflation, Weaker Demand and (more) Fiscal Uncertainties

February 2021

xp investimentos

Brazil Macro Monthly: Higher Inflation, Weaker Demand and (more) Fiscal Uncertainties

- We've now imbedded a new round of the Emergency Aid (EA) in our baseline scenario. The program's final format and the implementation process will be key to fully assess its impacts on the economy.
- The weaker activity at the beginning of the year should be offset by the new round of EA and by the prospects of normalization allowed by the vaccination. We maintain our GDP growth forecast at 3.4% in 2021 and 2.0% in 2022.
- The weaker currency and higher commodity prices led us to increase our IPCA forecast for 2021 to 3.9% (3.5% before). For 2022, we maintain 3.4%.
- The external sector continues to be an important anchor. We forecast the Current Account balance at 0.4% of GDP in 2021, the first positive result since 2007. In this context, the FX is expected to appreciate to 4.9 reais per dollar this year and 4.8 in 2022. The main risk lies on a disorderly implementation of Emergency Aid.

XP Forecasts

	2018	2019	2020	2021 (F)	2022 (F)
GDP growth (%)	1.3	1.1	-4.6	3.4	2.0
Unemployment rate (% s.a., end of period)	12.2	11.5	14.7	14.6	11.8
IPCA (CPI, 12m, %)	3.8	4.3	4.5	3.9	3.4
SELIC rate (% p.y., end of period)	6.5	4.5	2.0	3.5	4.5
FX (USDBRL, end of period)	3.9	4.0	5.2	4.9	4.8
Primary fiscal balance (% GDP)	-1.6	-0.9	-9.5	-3.5	-2.3
Gross debt (% GDP)	76.5	75.8	89.3	90.3	91.0
Trade Balance (USD Bn)	59.8	48.0	50.9	74	64
Exports (USD Bn)	241.0	225.4	209.8	259	267
Imports (USD Bn)	181.2	177.4	158.9	184	203
Current Account (USD Bn)	-41.5	-50.7	-12.5	6.9	-15.7
Current Account (% GDP)	-2.2	-2.7	-0.9	0.4	-0.9
FDI (USD Bn)	78.2	69.2	34.2	45.0	60.0
FDI (% GDP)	4.1	3.7	2.4	2.7	3.3

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

Foreword - Extension of Emergency Aid in Brazil: an opportunity and a risk

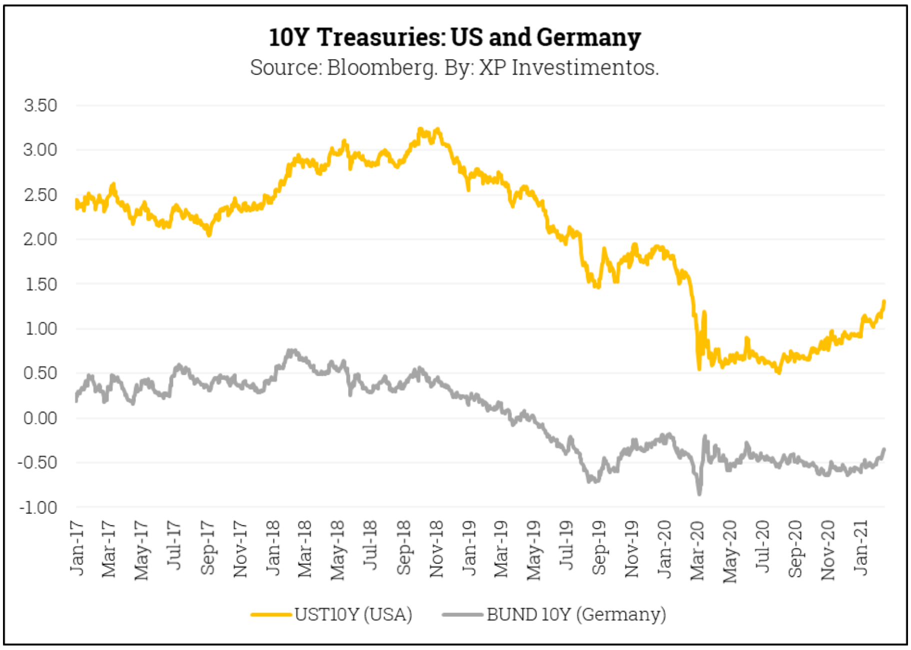
The global progress on the vaccination front and the strong government stimulus kept "reflation trade" live in global markets. Commodity prices continue to go up, and long-term yields are rising in developed markets (see chart). So far, so good: the global economy is normalizing, returning to its pre-pandemic levels. But if the stimulus packages – past and future - prove to be too much and this movement picks up, a hangover (in the form of worsening financial conditions) may lay ahead.

In Brazil, increasing Covid-19 cases and the disorderly discussion of extending fiscal stimulus added pressure to risk premium, reversing the BRL appreciation trend observed since mid-December. Weaker currency and high commodity prices mean inflation under pressure: we raised our IPCA forecast this year from 3.5% to 3.9%. Against this background, the BCB started signaling that rate hikes may come sooner than expected. Thus, after the last Copom meeting (Jan 20), we revised our forecast for the beginning of the tightening cycle from August to May.

More recently, the Ministry of Economy took the lead of the discussions on the extension of the Emergency Aid. Guedes' team claims a new round should be accompanied by measures to strengthen the fiscal governance framework, through constitutional triggers for spending cuts. If this happens, it will be positive: additional spending limited to the short term in exchange for a long term structural change in Brazil's most fragile front – public accounts.

The implementation risk, however, is elevated. First, it is not clear which triggers will be included in the government's proposal, nor whether Congress will approve them in a timely manner (the resumption of Emergency Aid is already announced to March). Second, Congress can increase the program's size, both in value per person and in the number of beneficiaries, regardless of the Executive's will. Finally, once the EA is approved, there may be pressures to extend the BEm (employment support program), the Pronampe (subsidized credit to SMEs) or even to create a more permanent income distribution program.

In other words: if poorly structured, the extension of the aid may be the serpent's egg for a more structural fiscal deterioration.
There should be more clarity on these issues in the coming weeks. Until then, market volatility is expected to remain high.



Global Economy: too much stimulus?

The **US** economy moved from the risk of a fiscal cliff in Q121, to the risk of policymakers trying to push activity too much --a development that could have negative consequences on the state of financial stability going forward. With the democratic party having had won the runoff elections, and taking into account the weak January jobs report, the probability of a large fiscal package (nearing USD $1.2-1.4 trillion) being approved in March or early April via reconciliation has increased materially.

It would mean an impulse worth north of 12% of GDP in 2021, with the economy already opening back up thanks to the success of the vaccination efforts. Moreover, the aggregate level of savings remains abnormally high. We believe that a large portion of those excess savings will eventually be filtered back into the economy.

We estimate the US economy is poised to expand 5.5% in 2021. On inflation, Headline and Core CPI are likely to increase 1.9% y/y and 1.8% y/y respectively in 2021, but only after touching 3.1% y/y (headline) and 2.4% y/y (core) in May.

Under this background, **we revised our YE 2021 10-Year UST to 1.5% from 1.3%.**

Regarding **China**, the high-frequency data that has been published since our January monthly appears to be showing that the economy is slowing somewhat from the frantic pace of growth that had been present up until the end of the fourth quarter of last year. Even though, we expect China to growth at impressive 9% this year.

On the external trade side, the data continues to show a picture of extreme robustness, underscoring the thesis that China has proven to be the main economic beneficiary of the pandemic. We reiterate our view that the USDCNY will be trading at 6.30 by year-end 2021.

In **Europe**, the recent developments surrounding the pandemic have taken a clear turn for the better, with new cases, hospitalizations and deaths falling materially. The hit to activity has proven to be less aggressive compared to our initial expectations. Nevertheless, the pace of vaccination in the Eurozone has continued to lag that in the UK and the US significantly.

Despite relatively high recent inflation numbers, we think the ECB will acknowledge that underlying inflation continues to be subdued and refrain from any policy action or indication that resembles any sort of unwinding the stimulus measures currently in place.

BRAZIL: Higher Inflation, weaker demand and (more) Fiscal Uncertainties

Economic Activity: weakening demand

Demand decelerated in the last quarter of 2020. Retail sales declined 6.1% in December, after a stagnation in November. The Monthly Service Survey fell 0.2% after six consecutive increases. Among the possible explanations are: i) a pay-back, after abnormally strong third quarter; ii) upfront 13th payment for retirees and pensioners during the first months of the pandemic, that removed a usual year-end income; and iii) inflation spike eroding consumers' purchasing power.

The picture is not expected to improve at the beginning of this year. Consumer and business confidence indicators dropped 2.7 and 1.6 points, respectively. The economy should also feel the interruption of the emergency aid, even if it gets reestablished in March. On the positive front, credit to households remain at a good pace, driven by favorable monetary conditions.

Industrial production, in turn, continues to show positive results, growing by 0.9% in December. With historically-low inventory levels, the sector should continue to grow, despite the slowdown in demand.

We estimate GDP has contracted 4.4% in 2020, resulting from 2.3% growth in the fourth quarter (see table). For 2021, we estimate a slight drop of 0.1% in the first quarter, caused mainly by the effects of the second wave of covid-19 infections and the slowdown in aggregate demand. On the other hand, the reestablishment of the emergency aid (see impact below) and progress on the vaccination front (we expect at least 30 million people vaccinated by July) bring a positive bias for the second half of the year.

Thus, we keep our forecast of 3.4% GDP growth this year. For 2022, with the economy closest to its potential, we expect 2.0% growth.

Impact of the new round of Emergency Aid

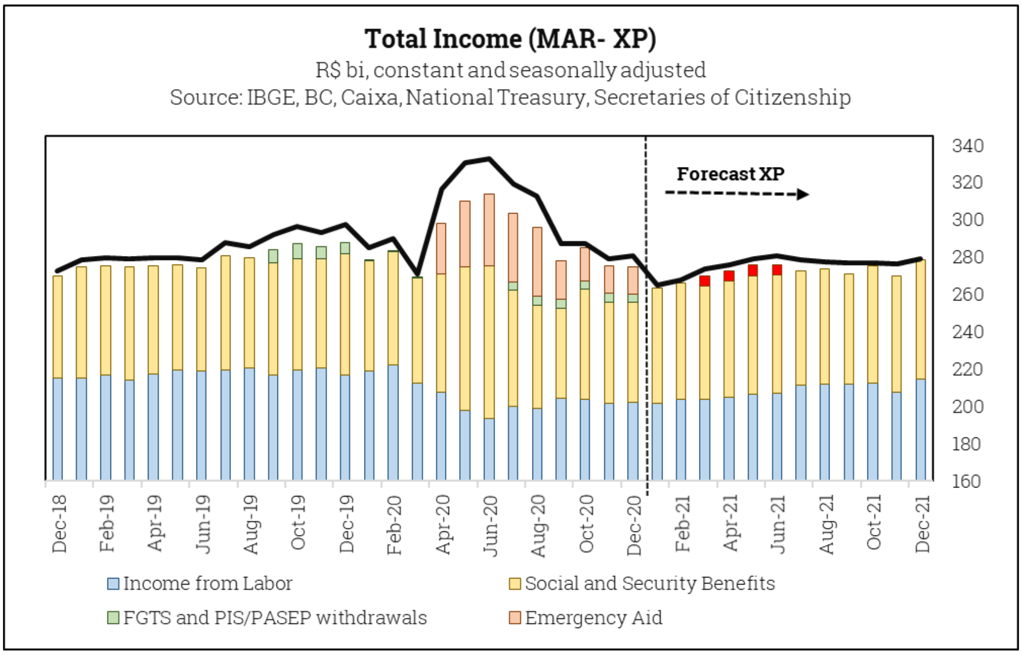
We now contemplate the reestablishment of emergency aid in our base scenario. We estimate the impact on total income of four payments at R$ 250 per person, starting in March (see graph). The impact on total income at the end of 2021 would be close to 1.0%.

Our aggregate demand model points to an increase of 0.13 percentage points in household consumption growth in 2H21 and 0.21 p.p. in 3H21. This means a positive contribution to GDP growth of 0.09 p.p. in 2H21 and 0.14 p.p. in 3H21.

The secondary effects of a new round of EA (not considered in our scenario) are ambiguous. If the program is accompanied by long term changes to curb spending, it may have an additional positive effect on GDP and unemployment. On the other hand, with no counterparts, the new round of stimulus may impact the level of risk premium, exchange rate and inflation, eroding the same benefits it is intended to bring to the poorest share of the population.

4Q20 GDP forecast			
	Var. % YoY	Var. % QoQ	2020
Agriculture	**1.0**	**0.5**	**2.2**
Industry	**0.4**	**0.9**	**-3.7**
Services	**-3.2**	**2.3**	**-4.7**
Tax	-2.4	-	-5.6
GDP	**-2.3**	**2.3**	**-4.4**
Household consumption	-4.2	2.3	-5.9
Government	-3.7	1.4	-4.6
Gross Fixed Capital Formation	3.4	7.4	-3.3
Exports	-0.3	1.2	-0.8
Imports	-18.1	3.0	-13.8

Source: XP Investimentos



Inflation: We raised our 2021 IPCA forecast to 3.9%. Spare capacity and monetary adjustment suggest deceleration in the medium term

Current inflation remains under pressure. The cooling that we expected for the beginning of the year was reversed by weaker exchange rate and the further increase in commodity prices. This shock is added to the pressures on durable and semi-durable consumer goods observed since last year, as a result of high production costs and the mismatch between supply and demand in the sector.

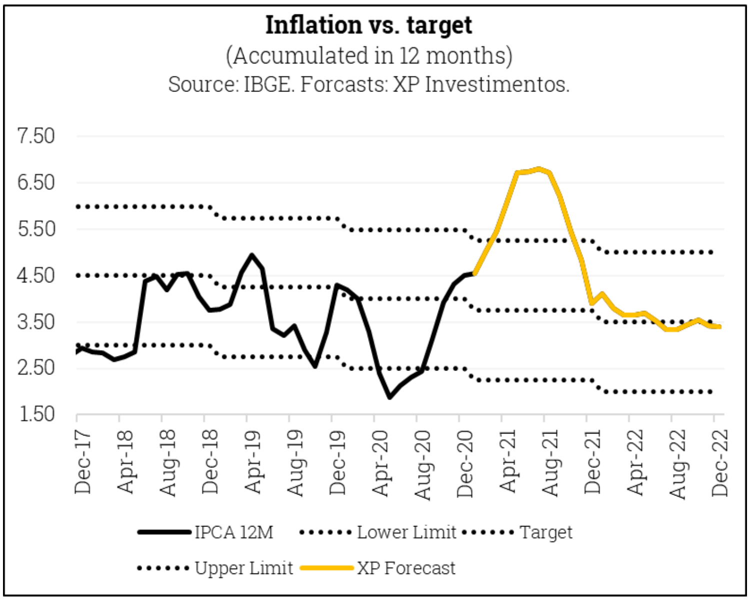
Moreover, the likely renewal of emergency aid smooths the expected deceleration in aggregate demand in the first half of the year, also taming its disinflationary effect. Further, the progress of the vaccination may allow some additional space for price hikes in the service sector.

Thus, we revised our forecast for the 2021 calendar year. We now expect IPCA at 3.9% this year (3.5% before). The main items we revised were food at home (from 3.6% to 5.0%), services (from 2.1% to 2.3%), semi-durable goods (from 3.5% to 3.8%) and durable goods (from 3.7% to 4.0%) - see table below.

		Before	After
IPCA 2021	**Weights**	**3.5**	**3.9**
Regulated Prices	**25.5**	**6.1**	**6.1**
Gasoline	5.0	7.5	7.5
Eletricity	4.3	1.6	1.6
Water and sewage	1.8	5.2	5.2
Bus Fares	1.3	2.4	2.4
Other regulated prices	13.1	7.5	7.5
Free Prices	**74.5**	**2.6**	**3.1**
Durable Goods	10.1	3.7	4.0
Semi-durable Goods	5.7	3.5	3.8
Services	36.1	2.1	2.3
Core Services	21.2	2.8	3.3
Food away from home	5.9	3.5	3.9
Other services	14.9	1.0	1.0
Non Durable Goods	22.6	2.8	3.7
Food at home	15.4	3.6	5.0
Olher non durable goods	7.2	1.0	1.0

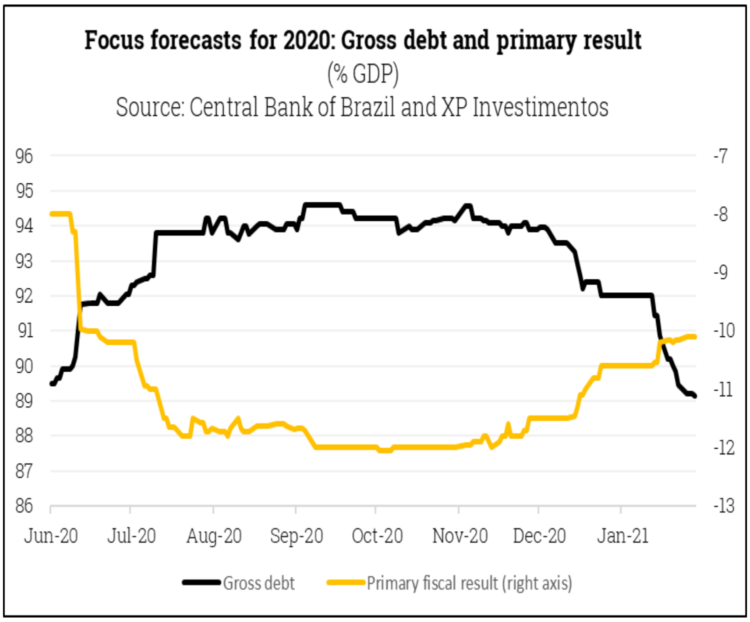
Over the medium term, the still large output gap – particularly in the labor market - and the reduction of monetary stimulus (see monetary policy section below) should contribute to the current pressure being restricted. The recovery in the supply of durable goods and the appreciation of the exchange rate embedded in our baseline scenario should also contribute to the reduction of inflation (see FX section below).

We maintain our forecast of 3.4% for 2022 (slightly below the target of 3.5%).



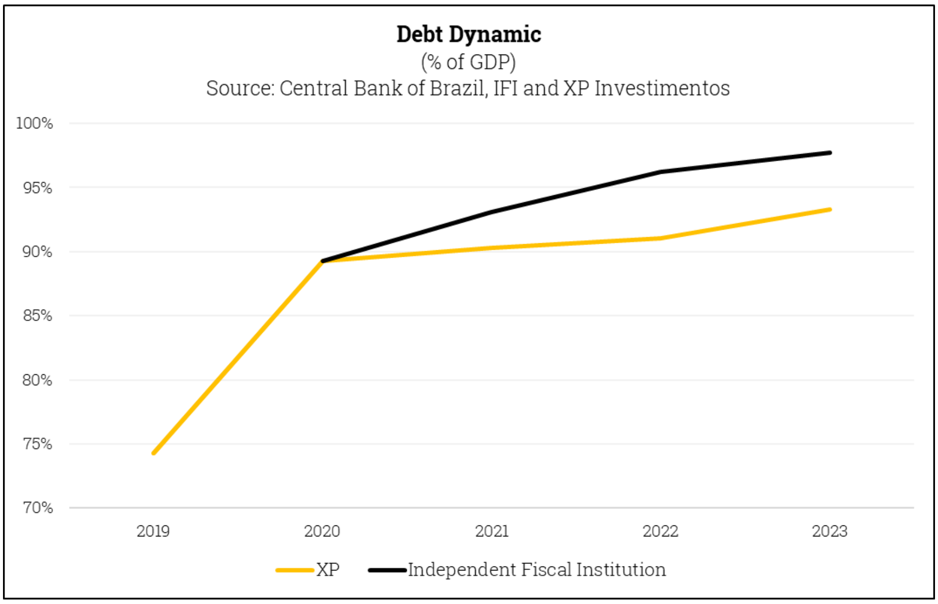
Fiscal - Risk persists, with pandemic and high debt

December fiscal results consolidated a better-than-expected picture in 2020, even in the face of the worst performance in recorded history. The change in expectations throughout the year can be seen in the dynamics of the Focus survey, which shows an improvement to 2020 fiscal projections in the last months of the year to a less negative scenario (see chart). Nonetheless, the primary deficit reached 9.5% of GDP and Debt-to-GDP ratio stayed a tad below 90% GDP mark, at 89.3%.



The positive surprise can be attributed in large part to the statistical review of nominal GDP by the IBGE, which trimmed approximately 2.2 p.p. from the gross debt-to-GDP ratio. But another part of the improvement is also explained by lower than expected spending with Covid-related programs and with social security; and by above expectations tax collection.

The marginally better fiscal results of 2020 and the re-acceleration of the pandemic generated pressure for a new round of the cash-transfer program "Emergency Aid". As described in the "activity" section, our scenario now includes a renewed program for 32 million beneficiaries, at R$ 250 per person, for a period of four months. The extra spending will be excluded from the spending cap rule, but it raises our primary deficit projection by R$ 30 billion, to -3.5% of GDP. We also adjusted our debt projection to 90.3% of GDP this year (from 90.1%), and to 91% for 2022 (from 90.9%).



Nonetheless, further risks remain high. First, this package-size that we imbedded in our baseline scenario seems to be the minimum required by Congress, at a risk of getting larger before approval. Second, it is unclear which fiscal counterparts - cost reduction or reinforcement of the fiscal management framework - will accompany the measure. It is also unclear whether, once the new round of EA is approved, pressure will also come to renew the employment-protection program "BEm" or the Pronampe (subsidized credit to SMEs).

In sum, despite the marginally better results in 2020, fiscal risks both in the short-term (pandemic) and in the medium-term (managing a debt approaching 90% of GDP) remain the main source of concern for the Brazilian economy.

External Sector is an anchor of stability in a sea of uncertainties

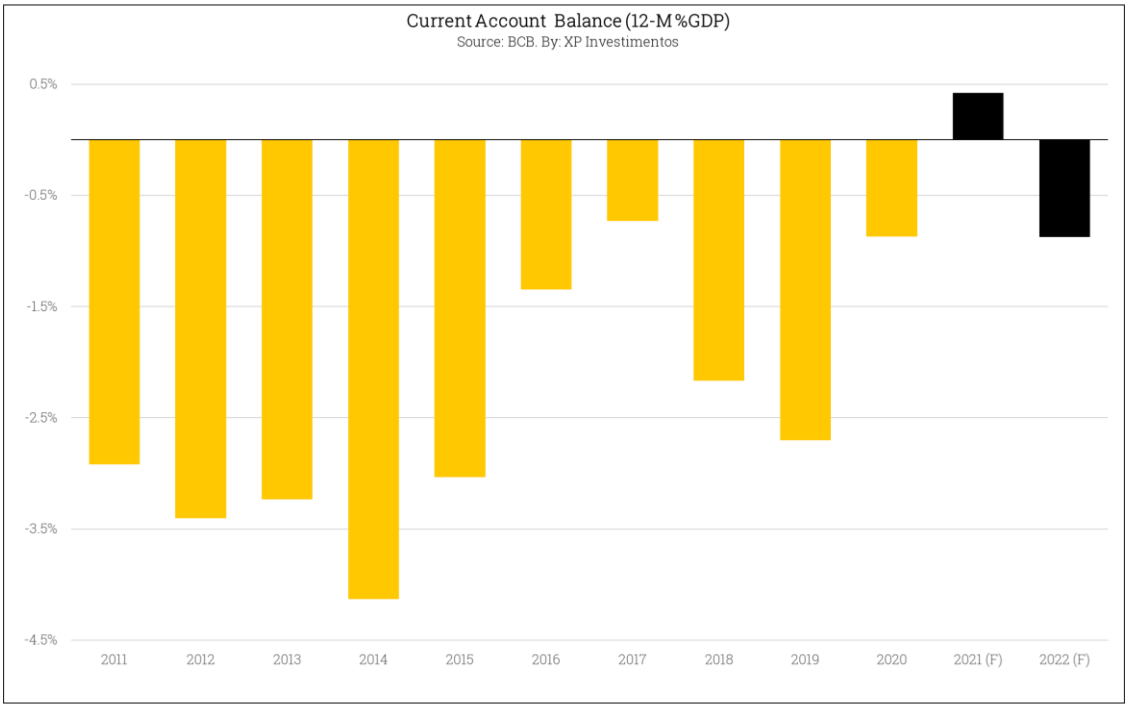
Brazil recorded a Current Account deficit of US$ 12.5 billion, or -0.9% of GDP, in 2020. The result was significantly better than 2019's (US$ -50.7 billion, -2.7% of GDP). The pandemic and the weaker BRL led to a fall in imports, a reduction in international travel and in rents (see details here, in our December's edition).

For 2021, we expect an even stronger result. Current account is expected to reach a surplus of US$ 6.9 billion, or 0.4% of GDP. Weak BRL, high commodity prices and the auspicious Brazilian harvests should boost exports to US$ 259 billion, from US$ 211 in 2020. The service and income account, in turn, should swing into negative territory, especially in the second half of the year, when the normalization of the economy tends to increase remittances of profits and dividends.

In 2022, assuming an almost complete return of economic activity, with the end of mobility restrictions, we understand Brazil will move back to negative current account balances – which is natural. We forecast U$ -15.7 billion (-0.9%).

Regarding the financial account, despite abundant global liquidity, stronger foreign investment will be contingent on reforms and growth outlook. We expect FDI to reach U$ 45 billion in 2021 and U$ 60 billion in 2022.

All in all, the external sector should remain a factor of stability for Brazil, in the face of so many challenges.



BRL floats with the tide, but with one foot on solid (fundamentals) ground

The BRL depreciated 5.2% in January, to R$ 5.47. Once again, it stood out as one of the worst performing currencies in the world. Ballooning Covid-19 cases and uncertainties regarding the vaccination process have renewed the fear of the pandemic and of its impacts on the economy - particularly on public spending.

On the other hand, commodity prices (as measured by the CRB index) rose 3.8% in the month and continued to rise in early February, when the Brazilian currency started to move closer to its EM peers.

For the rest of the year, the start of the Selic hiking cycle expected for the first semester and the positive dynamics of commodities should offset the underlying fiscal risks and the increase in the yield curve abroad, especially in the US.

Thus, we keep our BRL forecast at 4.90 per dollar at the end of 2021 and 4.80 at the end of 2022.

Monetary Policy – Aiming the beginning of the hiking cycle

The Copom has its finger on the trigger to start the monetary policy normalization cycle. The minutes of its last meeting revealed there to be already a discussion as to whether "it would still be appropriate to maintain an extraordinarily high degree of stimulus, given the normalization of the economic activity observed in recent months".

Indeed, the economy is no longer as weak as it was in the middle of last year, when the Copom set the Selic rate at 2.0%. Inflation forecasts have returned to the target path, and the beginning of vaccination - added to the probable renewal of emergency aid - reduces the risk of a double-dip recession ahead.

The question becomes when, and at what pace, the process will take place.

We believe that uncertainty above the usual and the still elevated spare capacity - especially in the labor market - reduce Copom's urgency. In addition, recent slowdown in demand may help taming price pressure in the consumer durable goods sector.

Thus, we believe the Copom will choose to wait for its May meeting to start the hiking cycle, with an increase of 0.25 pp. We see the Selic rate at 3.5% at the end of this year and 4.5% in 2022.

The biggest risk lies on the fiscal front. In particular, how the Executive and Legislative branches will implement the new round of the emergency aid. If it is not accompanied by relevant counterparts to improve the fiscal framework, or if the possibility of further extra-ceiling spending remains open (see fiscal section above), the risk perception tends to deteriorate, with effects on the exchange rate and inflation expectations.

This decision should occur until the beginning of March, before the next Copom meeting. If the more negative scenario materializes, the Copom will probably hike interest rates earlier - and more intensively - than contemplated in our baseline scenario.

XP Forecasts

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GDP growth (%)	1.3	1.1	-4.6	3.4	2.0
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