Brazil Macro Monthly

Higher risk perception, new scenario

March 2021

Brazil Macro Monthly: Higher risk perception, new scenario

- *Higher yields in DM bond markets, worsening of the pandemic, Petrobras turbulence and political challenges have led to higher risk perception towards Brazilian assets.*

- *Senate approved a relatively positive Emergency Constitutional Amendment (PEC), despite the watering down of fiscal counterparts and a new round of Emergency Aid larger than we expected. But the approval process was turbulent.*

- *We now expect the exchange rate at 5.3 reais per dollar at the end of 2021 (4.9 before). Weaker exchange rates and additional hikes in commodities prices put pressure on inflation. We raised our IPCA forecast for 2021, to 4.9% (3.9% before).*

- *The Copom will react more promptly to this scenario. We now see the Selic rate at 5.0% at the end of this year, to ensure IPCA back at the 3.5% target in 2022.*

- *Pandemic, market volatility, political uncertainty and higher interest rates affect economic output, despite the new round of emergency aid. We reduced our GDP growth forecast from 3.4% to 3.2% in 2021; and from 2.0% to 1.5% in 2022.*

XP Forecasts

	2018	2019	2020	2021 (F)	2022 (F)
GDP growth (%)	1.3	1.1	-4.1	3.20	1.50
Unemployment rate (% s.a., end of period)	12.2	11.5	14.7	14.60	11.80
IPCA (CPI, 12m, %)	3.8	4.3	4.5	4.90	3.50
SELIC rate (% p.y., end of period)	6.5	4.5	2.0	5.00	5.00
FX (USDBRL, end of period)	3.9	4.0	5.2	5.30	5.10
Primary fiscal balance (% GDP)	-1.6	-0.9	-9.5	-3.60	-2.30
Gross debt (% GDP)	76.5	75.8	89.3	89.80	92.50
Trade Balance (USD Bn)	59.8	48.0	50.9	74	64
Exports (USD Bn)	241.0	225.4	209.8	259	267.00
Imports (USD Bn)	181.2	177.4	158.9	184	203
Current Account (USD Bn)	-41.5	-50.7	-12.5	6.93	-15.67
Current Account (% GDP)	-2.2	-2.7	-0.9	0.42	-0.87
FDI (USD Bn)	78.2	69.2	34.2	45.00	60.00
FDI (% GDP)	4.1	3.7	2.4	2.70	3.30

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

Foreword - Scenario adjusts to greater risk perception

Since the publication of our last monthly report, the global and domestic economic scenarios have become more challenging.

In the external scenario, the process of rising long-term yields in DM bond markets continues. It's hard to say whether this reflects a normalization process following exceptionally low levels during the pandemic, or if it relates to a more persistent inflationary outlook. In any event, it seems safe to say that the external winds will blow less favorably moving forward.

In Brazil, the coronavirus pandemic has worsened, demanding tougher restrictive measures. Moreover, the change in Petrobras' leadership, the decision to subsidize diesel and cooking gas prices and the challenges in approving the emergency PEC all point to the direction of increasing political interference on economic policy. Finally, the decision by STF justice Fachin of suspending Lava Jato trial convictions against former President Lula will likely intensity electoral polarization looking into next year.

The Emergency PEC approved in the Senate was relatively positive, limiting the spending on a new round of Emergency Aid and improving fiscal governance. But the approval process was turbulent, including attempts for removing the Bolsa Família program from the spending cap, supported by government's allies. In the Lower House, President Bolsonaro signaled in favor of watering down counterparts.

Amidst a more uncertain scenario, risk premium in Brazil tends to become persistently higher. We continue to expect an appreciation of the exchange rate - reflecting external accounts surplus and higher domestic interest rates - but to a lesser extent: 5.3 reais per dollar at the end of this year (4.9 before). A weaker exchange rate leads to higher inflation this year and increases the need for the Central Bank to raise interest rates promptly, to keep inflation at the target in 2022.

Thus, we now see the Selic rate at 5.0%, coming from six consecutive increases of 50 bps starting in March.

The worsening of the pandemic, increasing market volatility and the faster removal of monetary stimulus weighs down on economic output, even with a new round of emergency aid. The result is lower GDP growth this year and next.

GLOBAL OUTLOOK

Higher long term yields: normalization or inflation?

The US economic recovery finally reached the labor market, with above-expectations figures in February. Still, even if employment growth goes into overdrive, it will take years before the economy is back to pre-pandemic levels.

The fixed income markets are trading with material level of angst, on the back of, among others, stronger ISM prices, higher commodity prices, and rebounding inflation expectations. We believe that a large portion of this inflationary pressure may be a function of supply shocks, tied to lockdown measures all around the world. Those shocks will be most likely corrected, once the world economy comes back to operating in an increasingly normal fashion.

We expect the Fed to react decisively to shield the ongoing economic expansion and the health of the housing market if at some point during the year fixed income markets start to evidence a behavior that resembles the “taper tantrum” of 2013.

We maintain our YE 2021 1.5% 10-Year UST target, but underscore that the risk to our call is clearly to the upside.

In Europe, recent data confirm a slight GDP contraction in 1Q21, mainly due to the Covid-related restrictions in key countries. Inflation dynamics remains benign. We expect annual inflation to increase north of 2%, but mainly driven by one-off factors. In 2022, we expect inflation to fall below 1%.

As a result, we expect the ECB to maintain a very accommodative monetary policy stance and to reinforce its commitment to adjust its asset purchase programs, if necessary, to maintain favorable financing conditions for the foreseeable future.

Regarding China, the high-frequency data has continued to show some economic slowdown from the frantic pace of last year. Still, the economy remains expanding at a solid pace.

We reiterate our long-standing view that the degree of animosity between the US and China will fall under a Biden administration. Still, a review of the current tariff structure is unlikely to happen.

Despite the latest impressive performance that the USD has shown, we reiterate our view that the USDCNY will be trading at 6.30 by year-end 2021.

BRAZIL

Fiscal – The PEC seems fine, but risks persist

In our previous monthly report, we noted that discussions on a new round of emergency aid were key for determining the economic scenario ahead. Not only on the fiscal front, but as the main driver of the increased volatility seen in Brazilian financial markets.

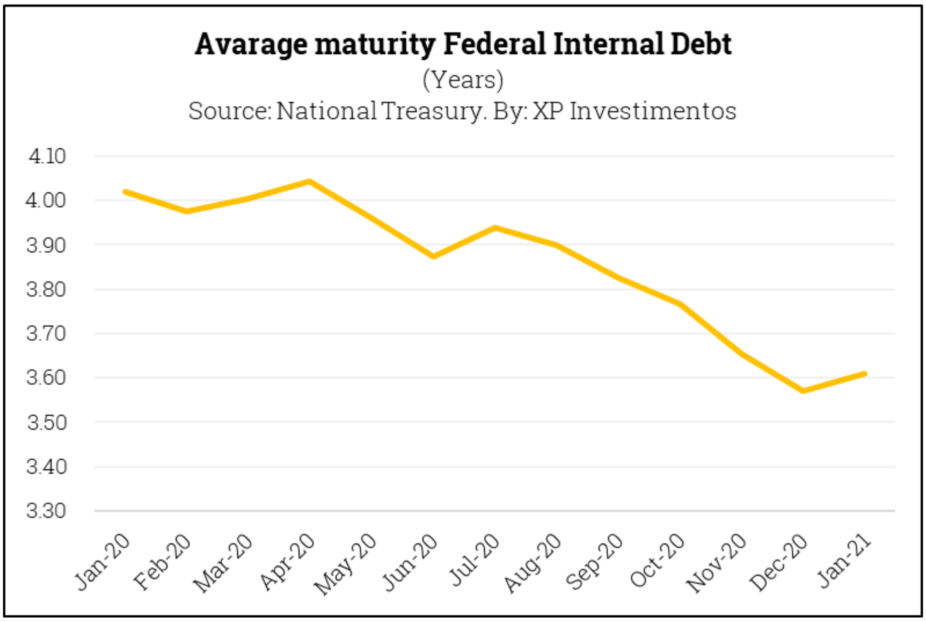
Fiscal data referring to the start of this year portrayed a slightly better picture than expected. The January result was driven by strong tax collection, better-than-expected performance of regional governments and lower non-mandatory spending. The 12-month primary deficit improved marginally, to 9.4% of GDP.

Nonetheless, the monthly fiscal results become irrelevant, as the pressure for higher spending growths stronger.

The Constitutional Amendment Proposal (PEC) approved in the Senate that allows for a new round of emergency aid was relatively positive, despite the watering down of long-term spending reduction triggers. However, the challenges faced by the government in approving it, which included (failed) attempts to bypass the spending cap, increase concerns over political stability.

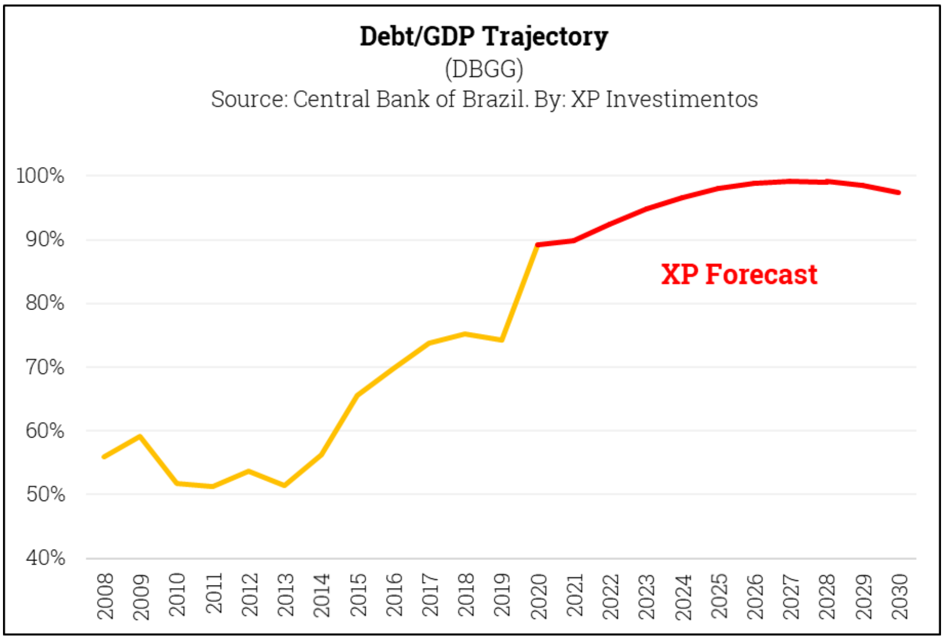
In terms of the fiscal impacts, the PEC includes a new round of emergency aid limited to R$ 44 billion -- slightly above what we anticipated (R$ 30 billion). Therefore, we altered our primary deficit projection to 3.6% of GDP (from 3.5%).

A higher expected Selic also impacts the level of indebtedness, especially given the recent shortening and the larger indexation to the Selic rate of public debt. This effect becomes increasingly relevant, given the R$ 31.8bn additional burden to the gross debt which follows every 1p.p. increase in the Selic rate (as per Central Bank's methodology).



On the other hand, higher expected inflation for this year increases nominal GDP, easing the effects of higher rates and primary deficit on the debt-to-GDP ratio.

All considered, we altered our debt-to-GDP ratio forecast to 89.8% (from 90.3%) for 2021, and to 92.5% (from 91.1%) in 2022.



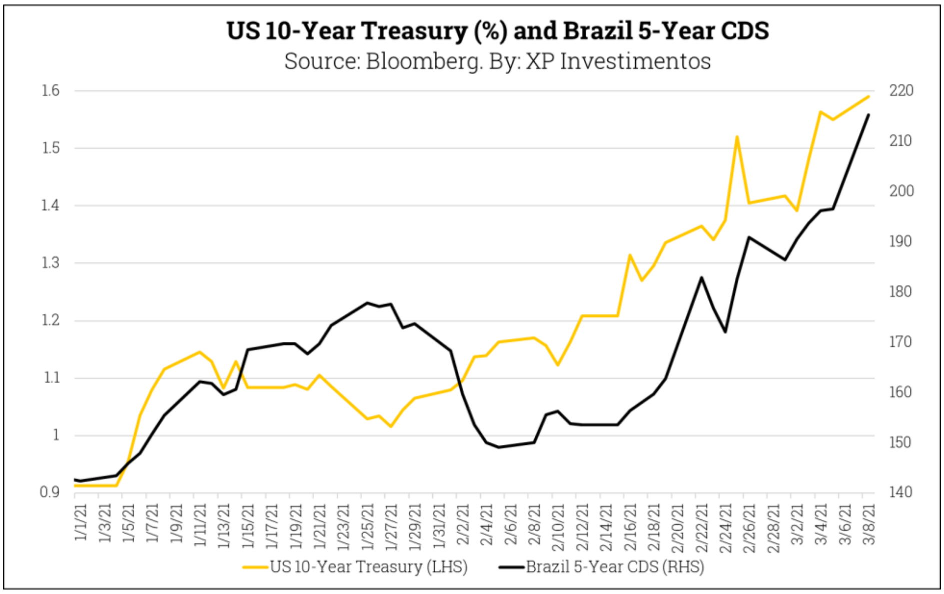
Exchange rate: Forecasts revised to R$ 5.30 in 2021 and R$ 5.10 in 2022

Brazilian exchange rate depreciated 2.4% in February to 5.6 reais to the dollar and reached R$ 5.85 in March. The movement reflects changes in the international and domestic scenario.

On the international scenario, the pressure was mainly driven by the increase in DM bond markets. The 10-year Treasury, for example, jumped from 1.06% in January to 1.56% in the first week of March. The movement is more intense and will probably be more persistent than we envisaged.

In Brazil, recent weeks were marked by the resurgence of the pandemic, the turbulent process of the emergency PEC in the Senate, increased political interference in state-owned companies and the decision by justice Minister Fachin regarding former President Lula’s conviction on Lava Jato.

The country's 5-year CDS went from 173 in January to 190 points in February and to 210 points in March. We understand that these risks have also been greater and will be more persistent than we have previously considered.



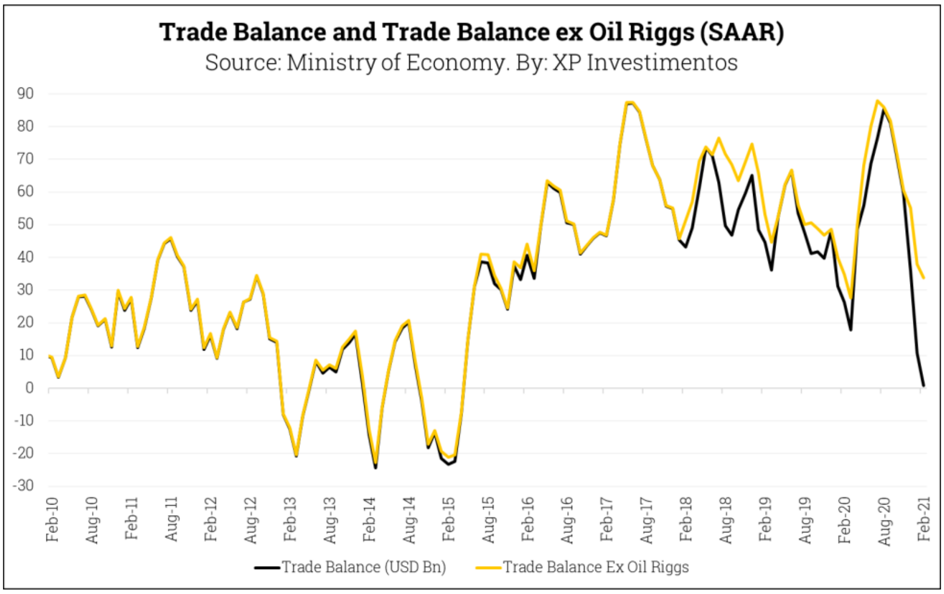
Our FX forecast also considers benign pressures, namely the positive trend seen in external accounts and the faster increase of the Selic rate.

Nonetheless, the exchange rate, in addition to being a macroeconomic variable, is also a financial asset. Thus, its trajectory tends to reflect structural drivers from external accounts (which remain positive), as well as the increase in likelihood of a more adverse fiscal scenario.

Therefore, we revised our 2021 exchange rate from R$ 4.90 to R$ 5.30, and from R$ 4.80 to R$5.10 in 2022.

Pandemic and currency weakness boost external accounts

Trade balance outlook remains favorable. We maintain our forecast of a surplus of US $ 74 billion for 2021, close to the seasonally adjusted average of 2H20. On the export side, the positive drivers are weak BRL, continuing rise in commodities prices and robust growth in China and the US. Imports, in turn, are expected to remain moderate, curbed by the currency and weaker GDP growth (see activity section below).



Such conditions will also have positive effects on other components of the Current Account balance. Increasing restrictions on travel and transportation will reduce the service deficit, as well as a more depreciated real will discourage remittances of profits and dividends abroad.

As a result, we also maintain our current account surplus forecast at $ 6.9 billion for 2021.

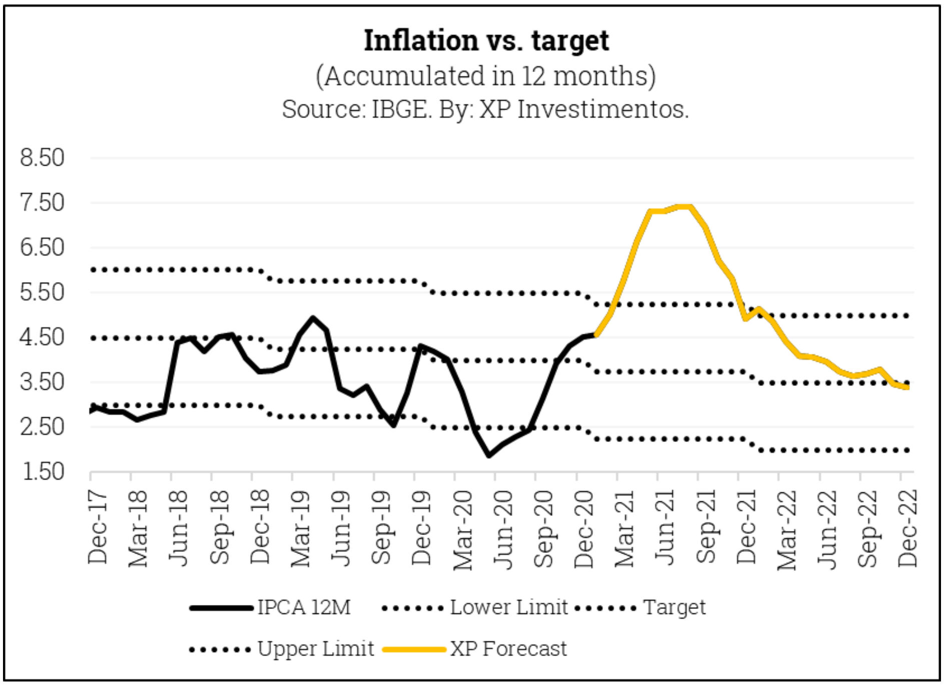
Inflation: weaker exchange rate adds pressure to 2021 CPI

As described in the previous section, we now expect a 8% more depreciated exchange rate this year, to 5.3 reais to the dollar. Moreover, the appreciation against the current levels (5.7) should be more concentrated in the second half of the year (along with progress on the vaccination front), keeping the exchange rate depreciated for most of the first semester.

The expected exchange rate trajectory is an additional shock to this year's inflation, which is already pressured by the continuous increase in global food and fuel prices; and imbalances between domestic supply and demand in the durable goods sector, which is taking longer to adjust.

Incorporating these effects, we revised this year's IPCA projection from 3.9% to 4.9%.

This year's higher inflation creates pressure on 2022. But we understand that the Central Bank will act promptly to reverse this impact (see monetary policy section below). Thus, we forecast the IPCA at the target of 3.50% next year.



IPCA 2021	Weights	Before 3.9	After 4.9
Regulated Prices	**25.5**	**6.1**	**6.4**
Gasoline	5.0	7.5	10.7
Eletricity	4.3	1.6	1.8
Water and sewage	1.8	5.2	5.4
Bus Fares	1.3	2.4	1.3
Other regulated prices	13.1	7.5	7.0
Free Prices	**74.5**	**3.21**	**4.4**
Durable Goods	10.1	4.0	4.9
Semi-durable Goods	5.7	3.8	6.7
Services	36.1	2.6	3.0
Core Services	21.2	3.7	3.7
Food away from home	5.93	3.9	5.2
Other services	14.9	1.0	1.9
Non Durable Goods	22.6	3,7	5.7
Food at home	15.4	5.0	6.0
Olher non durable goods	7.2	1.0	5.0

Monetary Policy: increased volatility calls for prompt reaction

The risks described in the previous sections makes monetary policy management more challenging going forward.

The more volatile and uncertain scenario calls for a prompt policy response. One that preserves the credibility of the inflation-targeting regime and keeps long-term inflation expectations well anchored.

Thus, our previous scenario which considered hikes of 0.25 p.p. leading the Selic rate to 3.5% in 2021 and 4.5% in 2022 does not seem to be enough anymore.

We adjusted our models so that the 2022 projection remained at the target of 3.5%. Thus, we now expect a faster and more intense tightening cycle, with increases of 0.50 pp per meeting starting in March, until the Selic reaches 5.0%.

We don’t rule out the possibility of Copom accelerating the pace, and reaching the intended 5.0% earlier, in case the exchange rate dynamics substantially worsens.

This level should remain throughout 2022, when we understand that current inflation and expectations will be in line with the target path.

Economic Activity: lower GDP growth expected for 2021 and 2022

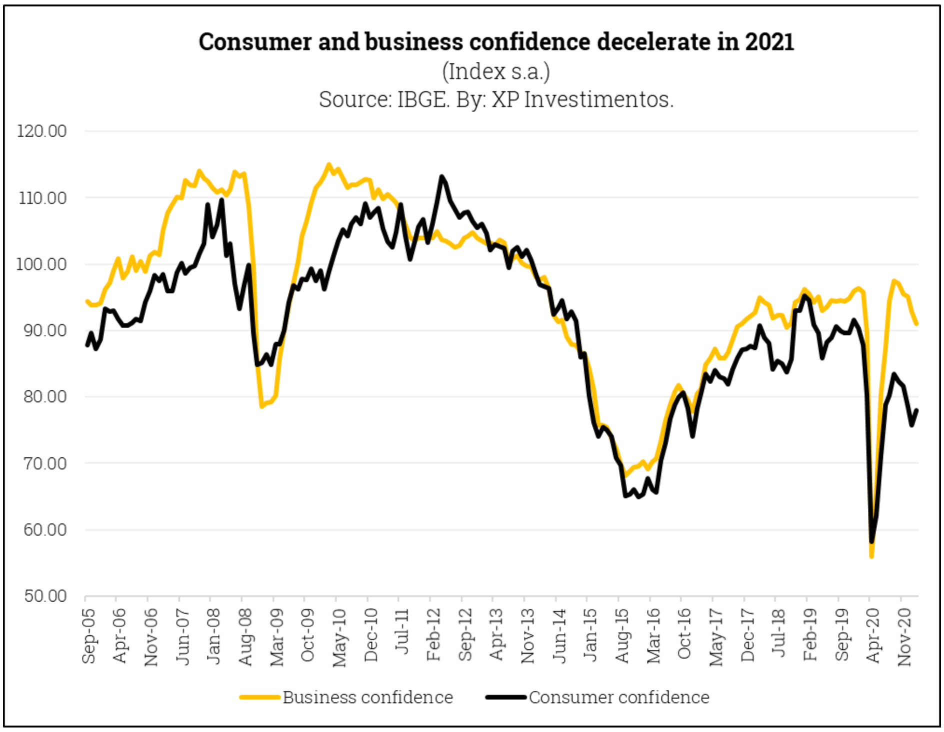
Brazilian GDP grew 3.2% QoQ in the fourth quarter of last year. With the result, GDP fell 4.1% in 2020. The result was better than expected, especially if we consider forecasts from earlier into the pandemic. And it leaves a statistical carry-over of 3.6% for this year. Albeit positive, the result says little about 2021.

Nonetheless, unlike the second half of last year, consumer's total income is falling – even with the likely renewal of the Emergency Aid. Similarly, the pandemic has worsened substantially since the end of 2021.

In addition, financial markets volatility has increased, with negative effects on financial conditions. One-year fixed interest rates, for example, rose 1.5 p.p. compared to December's average, to 4.4%. This rise in future interest rates should be largely sanctioned by the BCB's, as we discussed in the monetary policy section.

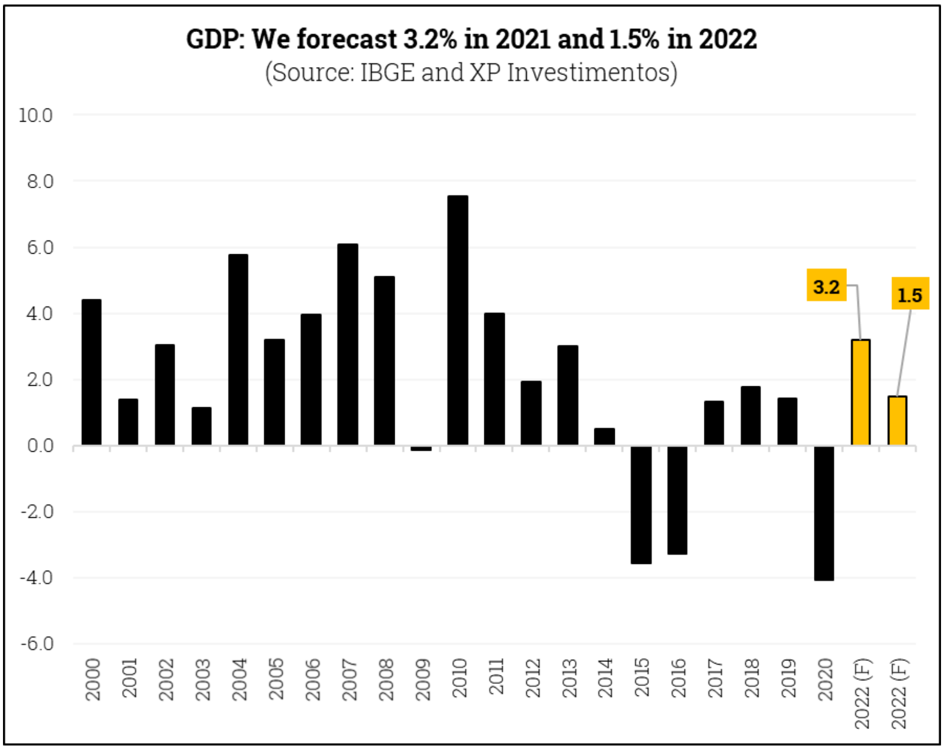
The fall observed in confidence indicators since December reflects the weakening context observed so far into 2021, which will not likely be reversed by a new round of emergency aid.

Considering these factors, we reduced our growth forecast in the first quarter to -0.5% (from -0.1% before). The second quarter also looks negative, due to the intensification of Covid-related restriction measures.



On the flip side, the progress of vaccination should pave the way for a gradual normalization process in the second half of the year, particularly in the service sector. By the same token, the new round of the emergency aid should help boosting consumer spending. As discussed in our previous report, we estimate a positive impact on GDP of 0.09 p.p. in 2Q2021 and of 0.14 p.p. in 3Q2021.

Considering the above, we revised the projection for GDP growth in 2021 from 3.4% to 3.2%. For 2022, the pace of economic output should be impacted by lower growth in 2021 and by the monetary tightening expected for this year. Thus, we revised our GDP growth forecast from 2.0% to 1.5%.



GDP Forecast - XP Investimentos			
	YoY	QoQ	12M
1Q21	-2.2	-0.5	-4.5
2Q21	9.7	-0.1	0.3
3Q21	3.6	1.3	2.3
4Q21	2.4	1.2	3.2
1Q22	1.7	-0.8	4.2
2Q22	1.1	-0.2	2.2
3Q22	1.7	1.5	1.7
4Q22	1.6	1.0	1.5

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

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