Brazil Macro Monthly

Market volatility has increased, but economic recovery continues to beat expectations

July 2021

xp investimentos

Brazil Macro Monthly: market volatility has increased, but economic recovery continues to beat expectations

- *Global economy continues to be favorable to Brazil, with high commodity prices and expansionary monetary policies.*
- *Economic activity remained strong throughout the second quarter. The better vaccination outlook reinforces the recovery of service sector. Thus, we raised our 2021 GDP growth forecast from 5.2% to 5.5%. With higher statistical carry-over and the likely expansion of the cash-transfer Bolsa-Familia program, we also revised the forecast for 2022 GDP to 2.3% (2.0% before).*
- *The stronger recovery of services activity is consistent with higher inflation pressure during the economic reopening. We increased our 2021 IPCA forecast from 6.4% to 6.6%. For 2022 we kept 3.6%.*
- *We keep our view that the Copom will step up the pace of interest-rate hike to 100 bps in its next meeting and reach a terminal rate of 6.75% in October. We see the exchange rate at 4.9 reais to the dollar at the end of this year and the next one.*
- *The income-tax reform proposal has improved after the dialogue with lawmakers. It brings, however, the risk of an excessive tax break. A more expansionary fiscal policy would be consistent to a tighter monetary policy (i.e., a higher terminal Selic rate).*

XP Forecasts

	2018	2019	2020	2021 (F)	2022 (F)
GDP growth (%)	1.3	1.1	-4.1	5.5	2.3
Unemployment rate (% s.a., end of period)	12.2	11.5	14.7	13.0	11.5
IPCA (CPI, 12m, %)	3.8	4.3	4.5	6.6	3.6
SELIC rate (% p.y., end of period)	6.50	4.50	2.00	6.75	6.75
FX (USDBRL, end of period)	3.9	4.0	5.2	4.90	4.9
Primary fiscal balance (% GDP)	-1.6	-0.9	-9.5	-2.2	-1.1
Gross debt (% GDP)	75.3	74.3	88.8	82.2	84.3
Trade Balance (USD Bn)	46.6	35.2	50.4	81.6	70.9
Exports (USD Bn)	231.9	221.2	209.2	280.1	291.8
Imports (USD Bn)	185.3	185.9	158.8	198.4	220.9
Current Account (USD Bn)	-51.5	-65.0	-24.1	-3.8	-20.6
Current Account (% GDP)	-2.7	-3.5	-1.7	-0.2	-1.2
FDI (USD Bn)	78.2	69.2	34.2	45.0	60.0
FDI (% GDP)	4.1	3.7	2.4	2.8	3.4

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

Foreword: Volatility raises again

It has been like this in Brazil. Just when it looks like we are going to have a couple of calmer months, a new round of uncertainty brings volatility – and risk premium – back to market prices.

Brazilian assets had been improving since April, driven by solid economic recovery, strong tax collections and (much) better terms-of-trade. Inflation is a problem, but the central bank is reacting firmly and independently.

However, the combination of political turmoil with the controversial income-tax reform proposal reversed part of the recent market rally.

External factors also contributed to the worsening of the markets. The Delta variant of Coronavirus has been spreading in many countries, the OPEC deadlock has pushed oil prices even higher and recent data shows the Chinese economy losing steam.

In our view, these domestic and external factors tend to be temporary. Furthermore, the world's main central banks should keep their ultra-expansionary monetary policy, even with short-term inflationary pressures.

Thus, we keep our exchange rate forecast at 4.9 reais per dollar at the end of this year, and we have raised our growth forecast from 5.3% to 5.5% this year, and from 2.0% to 2.3% in 2022. Stronger recovery of the service sector put additional pressure to 2021 inflation: we raised our IPCA forecast to 6.6% from 6.4%.

We believe that the Copom will accelerate the rate of interest rate hike to 1pp at its August meeting. We maintain our forecast for the end of the cycle at 6.75%.

The most import source of uncertainty seems to come from the political side, with the proximity of the electoral calendar. In this environment, fiscal expansion may be excessive, both in the final calibration of the tax reform or in the new Bolsa Família program. If fiscal expansion proves to be excessive, monetary policy will probably need to be tighter than we current forecast.

Global Backdrop: transitory inflation shock

Our models continue to show that US Core CPI will likely peak this month at 5.4% y/y in June before it starts to mean-revert towards 3.5% by yearend 2021. Looking forward to 2022, our models are showing that Core CPI will likely once again fall back below 2% on the back of (1) slower economic growth, (2) our conviction that there is no political capital to approve additional stimulus to consumers, and (3) our view that longer-term disinflationary pressures will linger in time in a post-pandemic world.

We believe that the timeline of the tapering process will be delivered at the Jackson Hole meeting this coming August. We believe that D-day for the initiation of the tapering process will be Q122, but the risk of seeing a Q421 initiation (most likely December) has increased significantly. We believe the liftoff will take place in Q323. We still think that the Fed Funds terminal rate will prove to be 2% and NOT 2.5% as the “dots” chart is currently hinting.

As we have argued in other research documents, despite the publication of materially higher-than expected inflation prints, we are holding on to our non-consensus and long-standing US 10-year YE 2021 1.5% forecast.

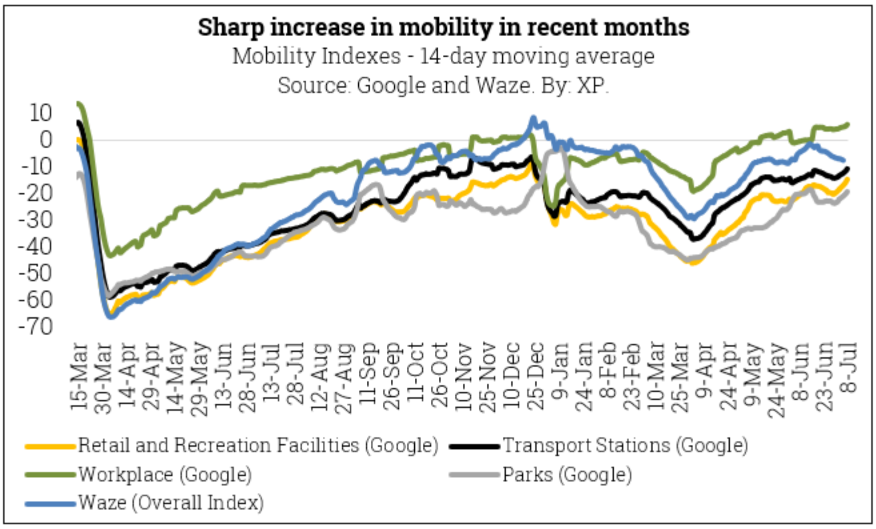
On Commodities, OPEC not being able to reach an agreement on production levels is the definition of a blessing for "shale country". This is one of the main reasons why I continue to believe that oil prices will not increase much further from current levels. The other reason is the very high level of inventories that the US currently holds. It should also help on the inflation front going forward.

In China, recent indicators suggest that the economy is gradually slowing down – what could be interpreted as good news, given the risk of overheating. Still, Q2 GDP grew at solid 7.9% y/y. We maintain our forecasts for 2021 and 2022 growth, at 9% and 6% y/y respectively.

Brazil: Economic activity continues to beat expectations: we raised our 2021 GDP forecast to grow 5.5% in 2021

Brazilian economy showed solid performance in Q2. After poor results in March, which were heavily affected by the worsening of the pandemic and subsequent adoption of tighter mobility restrictions, we have observed a steady recovery in the main activity indicators.

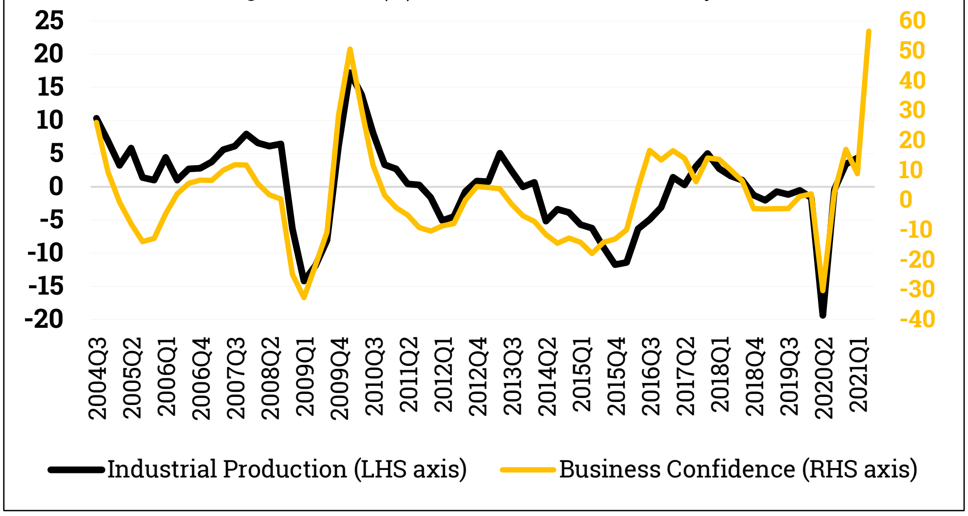
The economic reopening amid significant advances in the vaccination campaign against Covid-19 has explained, to a large extent, the better-than-expected recovery. In addition to increased mobility, (i) the new round of emergency cash-transfers to vulnerable people aimed at mitigating the effects of the pandemic, (ii) prepayment of social security benefits, and (iii) return of the Emergency Program for the Maintenance of Employment and Income (BEm) have also played an important role to supporting domestic demand.



We estimate 2Q21 GDP has grown 0.2% QoQ SA. Aggregate demand probably increased at a solid pace last quarter (around 1% QoQ). It is worth mentioning that a few months ago most of market participants – us included – forecasted negative figures for 2Q GDP.

The strong recovery in business and consumer confidence indexes point that domestic activity will gain steam in 3Q. In particular, services rendered to families (e.g. restaurants, events, travels) are likely to increase substantially in the short term, as the vaccination progresses. We believe that the adult population of Brazil will be fully immunized by the end of October. As we have argued, household consumption expenditure should exert a greater contribution to total GDP in the second half of this year, with a pivot from goods into services.

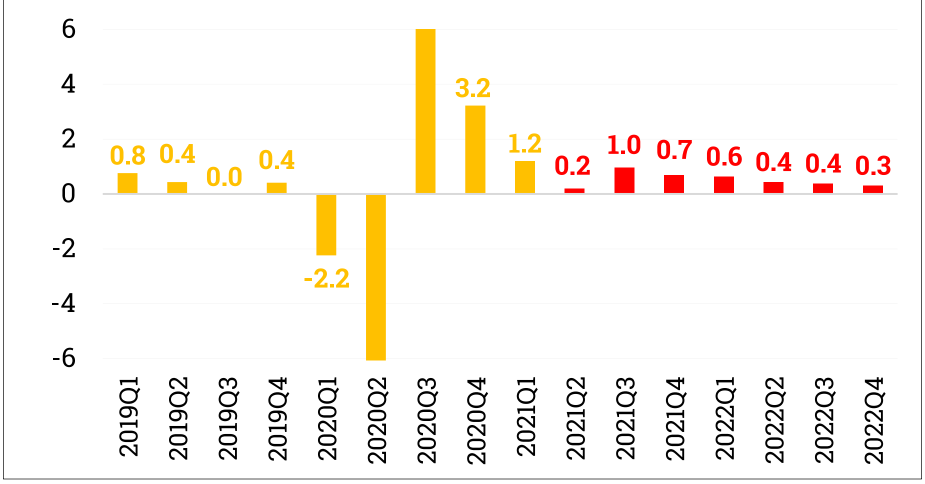
Furthermore, global demand will continue to boost exports, and solid investment in both capital goods and construction should support industrial output.



Rising confidence points to expansion in industrial sector
YoY growth rate (%). Source: IBGE and FGV. By: XP.

We forecast that total GDP will expand by 1.0% QoQ in 3Q and 0.7% QoQ in 4Q. Our previous estimates were 0.8% QoQ and 0.5% QoQ, respectively.

Under this backdrop, we raised our projection for 2021 GDP growth, to 5.5% from 5.2%.



GDP (% QoQ)
Source: IBGE. Forecasts by: XP.

If our forecasts for the quarterly GDP dynamics prove accurate, the statistical carryover effect implied for 2022 GDP growth will be 1.0% (previous estimate: 0.8%). Added to this, the new income transfer program to be implemented by the federal government (a broader version of the "*Bolsa Família* program") should lead to a net positive impact on next year's household consumption (accordingly, we estimate an effect of up to 0.15pp on 2022 total GDP growth).

Accordingly, we are also raising our expectation for 2022 GDP growth, to 2.3% from 2.0%.

GDP Breakdown (annual change - %)	2020	2021 (F)	2022 (F)
Agriculture and Livestock	**2.0**	**2.3**	**2.1**
Industry	**-3.5**	**6.2**	**1.8**
Services	**-4.5**	**5.4**	**2.5**
Total GDP	**-4.1**	**5.5**	**2.3**
Household Consumption	-5.5	4.8	2.4
Government Consumption	-4.7	2.6	1.5
Gross Fixed Capital Formation	-0.8	9.8	2.0
Exports	-1.8	7.3	3.0
Imports (-)	-10.0	8.4	2.6

Source: IBGE. Forecasts by: XP.

On the one hand, the moderate pace of economic growth expected for 2022 (average quarterly variation of 0.4% QoQ in our baseline scenario) considers the lagged effects of the tightening monetary policy and higher risk perception in an election year. On the other hand, it incorporates the still solid expansion in global economy and a gradual improvement in labor market conditions.

Impact on the labor market:

Lastly, we expect the national unemployment rate to decline from around 14.0% in the quarter ended in April (latest available data) to 13.0% at the end of 2021 and 11.5% at the end of 2022, based on seasonally adjusted figures. The recovery of the employed population in coming quarters should be accompanied by a gradual normalization of the labor force (i.e., a larger contingent of people looking for a job), which will limit the fall in the unemployment rate. The relative contribution of informal categories to total employment level should increase, as they are more sensitive to rising mobility. Despite that, the high spare capacity in Brazilian labor market will likely maintain real wages at low levels.

Inflation: on the back of stronger recovery in services sector, we revised the IPCA from 6.4% to 6.6% this year

Since the last Monthly report, some facts have impacted the outlook for inflation.

On the one hand, hydrological crisis forces local authorities to increase electricity prices even further. The impact of rising electricity prices is not restricted to electricity bills. As an important part of the production chain of various sectors of the economy, especially industry, costs should rise significantly and be partially passed on to consumers.

On the other hand, the National Health Agency announced an 8.19% cut in individual and family health plans for the period 2021/2022. We had zero in our forecast.

Those two drivers offset each other, what would mean no change in our 2021 IPCA forecast.

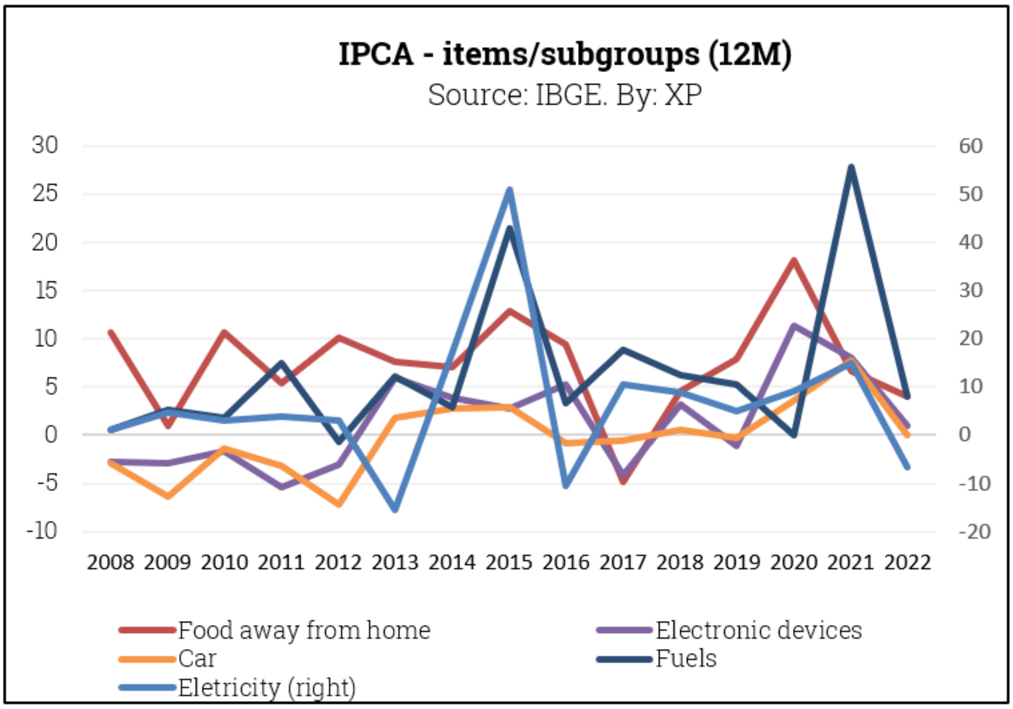
However, by incorporating a stronger service-sector recovery to our models (see section above), we lifted the services inflation forecast for the second half of 2021.

As a result, we raised our IPCA forecast for the year from 6.4% to 6.6%.

For 2022, we maintain our IPCA forecast at 3.6%, as lower electricity inflation (due to base-effect) tends to offset inertia from 2021 figures.

Is this intense disinflation expected from 2021 to 2022 feasible? We think so. Most of the inflationary pressure this year comes from volatile items with little inertia, such as fuel and electricity (see table and graph below). Thus, it is feasible that a relevant part of the current pressure will dissipate in the coming quarters.

	2021	
Items/subgroups	% Ch.	Contribution
Headline IPCA	**6.6**	**6.6**
Food away from home	6.7	1.0
Eletricity	14.8	0.6
Electronic devices	8.0	0.1
Used and new cars	7.8	0.4
Fuels	27.8	1.6
Total		**3.8**



Fiscal framework may get under pressure to allow further expenditures

Short-term fiscal numbers remain benign. Tax collections continue to excel, both in the federal government and in states and municipalities, spurred by strong economic activity. The result has allowed an improvement in fiscal forecasts for this year. **We now see primary deficit at 2.2% of GDP (2.4% before).**

Gross debt-to-GDP forecast remained at 82.2%, as the improvement in the primary balance was offset by the increase in the expected Selic rate (see the monetary policy section).

For 2022 we should see an increase in the space for discretionary spending, given that the Constitutional spending cap will rise by 8.35% (YoY IPCA by June), or R$ 124 billion. Considering that mandatory expenditures will also rise; **we estimate this space at around R$ 30 billion.**

The government has signaled that its priority is an increase in the cash-transfer program Bolsa-Familia, which would fill most of this gap. But there is also pressure for increase in civil servants' wages and for increase in public investment.

Thus, if boosting the Bolsa-Familia is an important political will, there is a risk of fresh pressures to change the current fiscal framework to fit the different pressures.

In addition to find space within the cap, the new program needs also source of funding to comply to the fiscal responsibility law (LRF, in the Portuguese acronym). The income-tax reform, that is in the Congress, can provide this source. But its approval faces resistance.

One alternative way would be to adapt the LRF to accommodate the program. In our view, it is a bad option, because it would represent a structural worsening on Brazil fiscal framework.

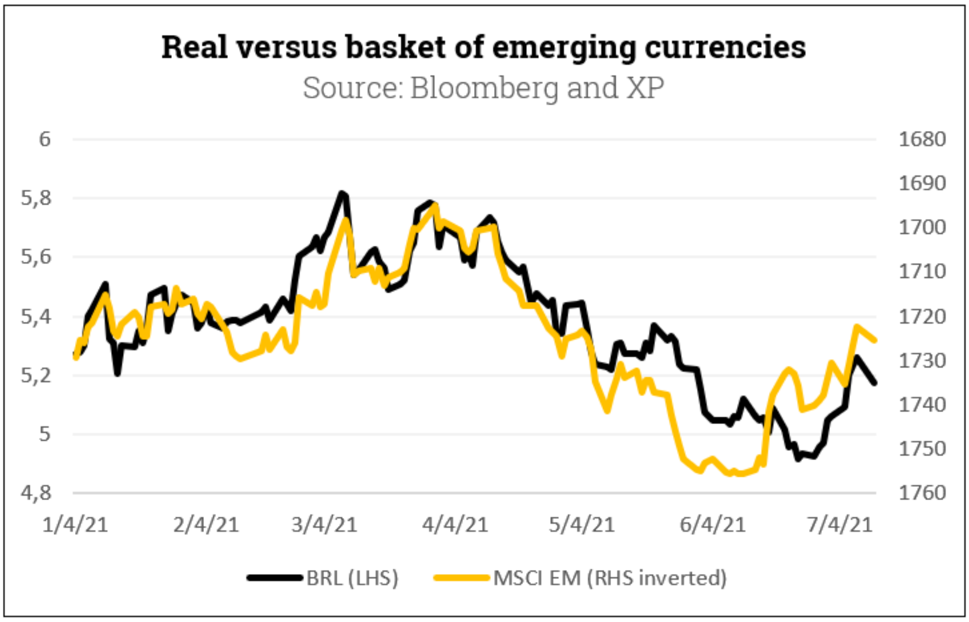
Income-Tax Reform

The government sent a tax reform proposal to the Congress, changing income-tax rules for individuals and corporates. The original proposal was negative in our view, as it would make the tax-system more complex and would increase the tax burden on companies.

The latest version of the proposal, adjusted by the rapporteur Congressman Celso Sabino, corrected most of the problems. But it may have become excessively expansionary, as it cut income-tax on corporates significantly. If approved as it is, it may offset part of recent gains in tax collection – what have helped to improve debt dynamics.

External Sector: higher volatility, but no change in fundamentals

Since our last monthly report, the real has depreciated from 5.00 to about 5.20 reais per dollar, or about 4%. In the same period, commodities were at a standstill and the basket of currencies of emerging countries depreciated around 1.5%, similar to the accumulated value of the real when adjusted for volatility.



The real performed well through the end of June with positive data on the trade side and the total flow, which was positive at USD 4.5 billion in the month even with exporters maintaining part of their revenues abroad.

However, political noises and the presentation of the text of the tax reform with a focus on income, in particular the perception of impacts on companies listed on the stock exchange, increased the search for protection and generated a correction that equalized our currency to its pairs in early June.

In addition to the volatility, we understand that there has been no change in the medium-term exchange rate fundamentals. **Thus, we maintain the projection of 4.90 reais per dollar for the end of 2021 and 4.90 for the end of 2022.**

Regarding the Balance of Payments, we maintain our forecast for a slight current account deficit, of 0.2% of GDP for the year, and for a gradual recovery in direct investment. It is worth noting that crop failures due to weather and a less favorable exchange rate now balance the bias towards the trade balance, which was previously a potential surprise towards an even larger surplus.

Monetary Policy – A more hawkish Copom

The Copom – Monetary Policy Committee of the Central Bank of Brazil – has become, in our view, more hawkish its recent communication. It signaled a monetary adjustment up to the neutral level but made it clear that what really matters is bringing inflation to the target path. And mentioned it may step up the hiking pace to achieve this goal.

Given the persistence of cost shocks (rise in commodities, domestic hydrological crisis) and the steady recovery of the economy **we expect two 100-bps hikes in August and September, followed by a final 50-bps increase in October (see our June 28th note for more details).**

At that pace, our models suggest the cycle could end with the Selic rate at 6.75. The exchange rate at around our forecast of 4.9 reais per dollar and some accommodation of commodity prices are important ingredients for this result.

However, if the risks mentioned in foreword of this report do not fade as expected, the Copom may need to take the Selic rate beyond the level we forecast.

XP Forecasts

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