Copom Warm-up: keeping the pace

Dataflow since the last Copom meeting was ambiguous for the inflation outlook, that remains challenging;

We believe that Copom's IPCA forecasts will rise for 2022 compared to the previous meeting, and decline for 2023;

We expect the Copom should raise the Selic by 1.5 pp and to signal "another adjustment of the same magnitude" for February. We believe the Copom to keep the wording of its monetary policy paragraphs unchanged in the post-meeting statement.

In our baseline scenario, we forecast two increases of 1.50 pp in the Selic rate in December and February followed by a final 75-bps hike in March, taking the Selic rate to 11.50% at the end of the tightening cycle.

Hawk-Dove Heatmap: a more balanced dataflow

The dataflow since the last Copom was, in our view, ambiguous for the inflation outlook.

On the one hand, **current inflation remains under pressure**, with the IPCA core measures running above 10%. Furthermore, the PPI figures still suggest cost-push inflation that may be passed through consumers in the coming months.

High current inflation and recent fiscal deterioration add pressure on inflation expectations. Central Bank's focus survey (compiled by professional forecasters) points to a 2022 IPCA already above the upper bound of the target range. For 2023, projections started to drift away from the target (3.25%), reaching 3.5% in the last reading.

On the other hand, activity lost steam earlier than expected, and it is now **a consensus that the economy will likely see a recession in 2022**. Weaker domestic demand indicates that, in 2022, it will be more difficult to pass on cost increases to consumer prices.

By the same token, **global commodity prices are showing signs of accommodation**, with prospects for a less expansionist monetary policy in different countries. Particularly, oil prices dropped significantly, which may open room for gasoline deflation ahead.

Another positive factor is that the rainfall regime is above expectations, increasing the probability of lower electricity prices next year (Brazil's energy generation is mostly hydrological).

All in all, our view is that data since the last Copom has moved the balance of risks on both sides, leaving the inflation scenario still challenging. Thus, the Copom should keep the strategy indicated in the last meeting's communication.

Hawk-Dove Heatmap*

Variables	May-21	Jun-21	Aug-21	Sep-21	Oct-21	Dec-21	Comment
Exchange rate (Ptax)	5.4	5.1	5.2	5.3	5.6	5.7	BRL weakened due to domestic and external risks
Ex-ante real interest rate (%)	1.1	1.7	3.1	3.7	5.5	6.1	Much tigher financial conditions
GDP 2021 Fcst (%, Focus)	3.1	4.9	5.3	5.0	5.0	4.7	Weak current activity data
GDP 2022 Fcst (%, Focus)	2.3	2.2	2.1	1.6	1.4	0.5	Market foreseeing a recession in 2022
Output gap	-2.4	-2.3	-2.0	-1.8	-1.7	-1.7	Output gap should remain negative for longer
IPCA 12m (%)	6.1	8.1	8.4	9.7	10.3	10.7	Current inflation continues to run at high levels
IGP-M 12m (%)	31.1	37.0	35.8	31.1	26.9	18.9	Cost-push inflation remains elevated
IPCA 2022 Fcst (Focus, %)	3.64	3.78	3.81	4.1	4.4	5.2	Rising steadily
IPCA 2023 Fcst (Focus, %)	3.3	3.3	3.3	3.3	3.3	3.5	Drifting away from the target
FGV Uncertainty Index	119.9	122.3	119.3	119.4	133.7	122.2	Improved a bit since last Copom
CDS 5y	192.1	159.9	176.6	180.6	232.0	237.0	Has stabilized in a relatively high level
Treasury 10y (%)	1.7	1.6	1.3	1.4	1.6	1.4	Global liquidity remains abundant
Brent US$	69.3	72.7	76.3	75.3	86.2	71.9	Recent drop may help with desinflation ahead
CRB CMDT Index	532.1	563.5	562.2	555.5	568.3	568.8	Has stabilized in a high level
Occupation of ICU beds	79.1	82.3	49.9	32.6	27.5	36.0	Worsened a bit
Deaths by Covid (mm7d)	2480.7	2000.0	987.0	532.0	337.0	214.0	Continues to improve
Mobility index (Google)	-20.0	-33.0	-10.0	-7.0	-3.0	1.0	Normalising
Reservoirs levels (%)	34.7	31.4	26.1	19.9	17.2	19.6	Better rainfalls recently should reduce pressure ahead

*The shades definition takes into account the historical evolution of the indicator, and a judgment component of the XP Macro team

BCB model: higher 2022, lower 2023

At the last Copom meeting, BCB's model forecast for inflation in the baseline scenario was of 9.5% for 2021, 4.1% for 2022 and 3.1% for 2023. Since then, the scenario has changed significantly, as illustrated in the heatmap above. This will also be reflected in the forecast for the IPCA in the baseline scenario.

The median of Selic rate forecasts in the Focus survey rose from 8.75% to 9.25% in 2021 (end of period), from 9.5% to 11.25% for 2022 and from 7.0% to 8.0% for 2023 since the last Copom. The exchange rate was stable at R$5.60/US$. Inflation expectations, also collected in the Central Bank's Focus survey, went from 9.0% to 10.2% in 2021, 4.4% to 5.0% in 2022 and from 3.3 to 3.5 in 2023.

While a higher Selic contributes to reducing in inflation, rising inflation expectations act in the other direction. The net effect on market price inflation (75% of total IPCA) should be 0.4 pp. Regulated price inflation forecast (25% of IPCA) should also rise - from 17.1% to 17.5%.

All considered, the IPCA forecast for 2021 in the baseline scenario should rise to 10.0% from 9.5%.

Of most relevance, however, are the numbers for 2022 and 2023. The forecast for the 2022 IPCA rises from 4.1% to 4.4% in the BCB base model, due to inertia from 2021 and higher market expectations. **On the other hand, the forecast falls for 2023, from 3.1% to 3.0%, due to tighter monetary policy.**

Brazilian Central Bank: Base Scenario									
	2021			2022			2023		
	Previous Copom	This Copom	Impact on IPCA	Previous Copom	This Copom	Impact on IPCA	Previous Copom	This Copom	Impact on IPCA
Exchange rate	5.60	5.60	0.00	5.60	5.60	0.00	5.60	5.60	0.00
CRB**	569.3	572.3	0.00	-	-	0.00	-	-	0.00
Interest rate Selic (year-end)*	8.75	9.25	-0.02	9.50	11.25	-0.37	7.00	8.00	-0.24
Inflation expectations*	9.00	10.18	0.09	4.40	5.02	0.39	3.30	3.50	0.12
Inertia	-	-	0.25	-	-	0.08	-	-	0.03
IPCA	**9.50**	**10.02**	**0.52**	**4.10**	**4.36**	**0.26**	**3.10**	**2.98**	**-0.12**
Market-set price	6.97	7.53	0.42	3.73	3.90	0.13	2.43	2.27	-0.12
Monitored price	17.10	17.50	0.10	5.20	5.72	0.13	5.10	5.10	0.00

* Focus survey - reference period November 3rd 2021

** We consider the entire impact of CRB increase in 2021. For 2022 and 2023, the effect is via inertia.

Implementation of Monetary Policy and Communication: no changes

We believe the Copom won't change its strategy in this week's meeting. It will deliver the signaled of 150-pbs hike and will continue to signal "another adjustment of the same magnitude" for January.

Therefore, we expect the Copom **to keep the wording of its monetary policy paragraphs unchanged in the post-meeting statement.**

What are the possible alternative scenarios? **A hawkish decision** would be to step up the pace, given the rise in inflation expectations (especially for 2023). In this case, the Copom would raise 1.75%, leaving the doors more open for the next meeting.

Another possibility, on the dovish side, **would be to signal that the Copom will focus more on 2023 target rather than on 2022's.**

Given the known lags with which monetary policy acts, it is normal for the Copom to roll over the relevant horizon. But, by historical standards, it's early to do that (this normally takes place early in the year). In our view, this would be an unnecessary dovish sign, particularly amid rising inflation expectations.

XP Scenario: a big challenge for the Copom

Brazil's Central Bank faces an huge challenge on the monetary policy front. Consumer inflation continues to run well above the target path and there's still pressure in wholesale prices to be passed on to consumers.

In 2022, the pass through will not be as immediate it has been this year. Domestic demand is already weakening, and the bulk of the monetary tightening already implemented by the BCB is still to be felt by the economy.

However, the uncertain scenario abroad and the deterioration of fiscal policy domestically do not allow the BCB to "wait and see". Therefore, the monetary authority should keep the tightening pace in order to anchor inflation expectations, even if it leads to an "overkill" ahead.

Thus, in addition to the 150-bps rise in the Selic rate this week, we now foresee another 150-bps hike in January, followed by a final 75-bps hike in March, **taking the Selic rate to 11.50% at the end of the tightening cycle**.

It is a level significantly above the rate we consider "neutral" (around 7.50%). In the absence of global shocks or further deterioration in fiscal conditions, **this level should be enough to foster a gradual convergence of inflation to the target path until 2023.**

If we are right and inflation starts to reduce over the next year, **the BCB will find room to start reducing the Selic back to "neutral" still in 2022**, with a 0.50pp cut in December.

XP Economic Research

Disclaimer

This material was prepared by XP Investimentos CCTVM S.A. (“XP Investimentos” or “Company”) and should not be considered as a research material for the purposes of article 1° of CVM Instruction 598/2018. All opinions, projections and estimates constitute the judgment of the author as of the date of transmission and these, plus any other information contained herein, are subject to change without prior notice. The Company does not support or oppose any political parties, political campaigns, candidates, or public officials. Furthermore, XP Investimentos is not permitted to give corporate funds, property or other resources to political parties or candidates and will not reimburse any shareholders, directors, officers, employees, and licensors for such contributions or expenditures. XP Investimentos and its affiliates, parents, shareholders, directors, officers, employees, and licensors will not be liable (individually, jointly, or severally) to you or any other person as a result of your access, reception, or use of the information contained in this communication.

Past performance is no guarantee of future results. Therefore, nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient’s individual circumstances or otherwise constitutes a personal recommendation. This report is published solely for information purposes, it does not constitute an advertisement and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. This material (including any attachments) is confidential, may contain proprietary or privileged information and is intended for the named recipient(s) only.