Copom Warm-up

Becoming data-dependent

Highlights

- We understand that the data analysis since the last Copom should leave its members marginally more concerned about the disinflation process ahead, due to pressured current inflation, high expectations and an increase in the price of commodities at the beginning of the year. Decelerating activity and less pressure on the exchange rate partially alleviate the scenario;

- Our simulations replicating the Copom model suggest an increase in the 2022 IPCA projection from 4.7% to 5.0% and the maintenance of the 2023 projection at 3.2%. A possible change from the tariff flag hypothesis to electricity would reverse the increase in the projection for 2022;

- We expect an increase of 1.5pp in the Selic rate at this meeting. As we advance, considering the monetary adjustment already implemented and the interest rate above the level we believe neutral, we expect the Copom to stop signaling "an adjustment of the same magnitude" at the next meeting;

- The challenge is not to sound too optimistic about inflation ("dovish"). To this end, we understand that the Copom will indicate that it will calibrate the next step depending on the data and will maintain the "persistence" signal.

Hawk-Dove Heatmap: inflation shows no signs of cooling

The newsflow since the last Copom was, in our view, **slightly negative for the inflation outlook.**

Economic activity continued to point toward a significant deceleration in final demand, although data for November were better than expected. The GDP forecasts for 2021 and 2022 collected by BCB's Focus survey have dropped since the last Copom.

Another positive factor was the dynamics of the exchange rate. Despite the rise in bond yields in developed markets, the Brazilian exchange rate has appreciated 3.5% since the last Copom.

Finally, the hydrological scenario improves, increasing the probability of substantial electricity deflation this year. The level of the reservoirs is already 10pp above the same period last year.

Current inflation, however, shows no sign of cooling, keeping inflation expectations under pressure. The mid-month IPCA-15 showed high variation in all core measures in January, while the IGP-M revealed additional pressures at wholesale, which may pass-through consumer prices in the coming months.

Behind the pressures on wholesale indices is a new round of commodities prices increase. Brent crude oil exceeded 90 dollars a barrel, iron ore rose 24,7% since the last Copom. Grains prices are also on the rise, reflecting unfavorable weather conditions in the South of Brazil.

All in all, we believe that the news flow since the last Copom should make its members marginally more concerned with the expected disinflation process.

Hawk-Dove Heatmap*

Variables	Jun-21	Aug-21	Sep-21	Oct-21	Dec-21	Jan-21	Comment
Exchange rate (Ptax)	5.1	5.2	5.3	5.6	5.7	5.4	Decompression in the last few days
Ex-ante real interest rate (%)	1.7	3.1	3.7	5.5	6.1	6.7	Significant increase, due to worse financial conditions
GDP 2021 Fcst (%, Focus)	4.9	5.3	5.0	5.0	4.7	4.5	Current activity data weakened
GDP 2022 Fcst (%, Focus)	2.2	2.1	1.6	1.4	0.5	0.3	The market already projects recession on 22
Output gap	-2.3	-2.0	-1.8	-1.7	-1.7	-1.8	Output gap should remain negative for longer
IPCA 12m (%)	8.1	8.4	9.7	10.3	10.7	10.1	Pressed and diffuse current inflation
Core IPCA annualized 3MMA	6.8	7.8	8.1	8.8	9.7	9.0	Small improvement, still very high
IGP-M 12m (%)	37.0	35.8	31.1	26.9	18.9	17.8	Additional cost pressure on the pipeline
IPCA 2022 Fcst (Focus, %)	3.78	3.81	4.1	4.4	5.2	5.4	Stabilized above the top of the tolerance band
IPCA 2023 Fcst (Focus, %)	3.3	3.3	3.3	3.3	3.5	3.5	Stabilized, but slightly above target
FGV Uncertainty Index	122.3	119.3	119.4	133.7	122.2	122.3	Improved a little since the last Copom
CDS 5y	159.9	176.6	180.6	232.0	237.0	299.9	Has stabilized in a relatively high level
Treasury 10y (%)	1.6	1.3	1.4	1.6	1.4	1.8	It started to expect more intense interest rate hikes in the short term
Brent US$	72.7	76.3	75.3	86.2	71.9	89.9	Returned to highs in 8 years
CRB CMDT Index	563.5	562.2	555.5	568.3	568.8	584.0	Commodities in general rising, beyond oil
Occupation of ICU beds	82.3	49.9	32.6	27.5	36.0	64.0	It got worse again with the omicron
Deaths by Covid (mm7d)	2000.0	987.0	532.0	337.0	214.0	627.0	It got worse again with the omicron
Mobility index (Google)	-33.0	-10.0	-7.0	-3.0	1.0	-6.0	It got worse again with the omicron
Reservoirs levels (%)	31.4	26.1	19.9	17.2	19.6	33.6	Normalizing, probable energy deflation

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

BCB model: 2022 forecast should rise unless the electricity flag hypothesis adjusts

At the last Copom meeting, the inflation forecasts in the BCB base scenario were 4.7% for 2022 and 3.2% for 2023.

Since then, the median of Selic rate forecasts in the Focus survey rose from 11.75% to 11.25% in 2022 (end of period) and stood at 8.0% for 2023. The exchange rate strengthened to R$5.45/US$ from R$5.65/US$. Inflation expectations, also from BCB's Focus survey, edged up from 5,0% to 5,4% for 2022, and it has been stable at 3.5 for 2023.

While a higher Selic and stronger FX contribute to reduce inflation forecast, higher inflation expectations and commodity prices act in the other direction. The net effect on market price inflation (75% of total IPCA) should be negative in 0.15 pp.

Regulated price inflation forecast (25% of IPCA) should also rise - from 3.8% to 5.8% - due to the rise in oil prices, which significantly changes the Copom's fuel price forecast. Another item that will probably boost the Copom's regulated prices forecast is property taxes on vehicles (the so-called IPVA). It came out significantly above our expectations in January, which *we assume* surprised the Copom as well (the Committee do not disclose this forecast).

All considered, the IPCA forecast for 2022 in the baseline scenario should rise to 5.0% from 4.7%.

For 2023, higher Selic rate for 2022 and 2023 reduces the IPCA forecast at the end of the period: -0.10 pp. On the other hand, the inertia from higher 2022 forecast raises the 2023 market prices forecast by 0.07 pp, and regulated prices forecast by 0.07 pp.

All in all, for the 2023 IPCA, it remains stable at 3.2% in the BC baseline model.

Brazilian Central Bank: Base Scenario						
	2022			2023		
	Previous Copom	This Copom	Impact on IPCA	Previous Copom	This Copom	Impact on IPCA
Market-set prices(I)	5.0	4.8	-0.15	2.5	2.5	-0.04
Exchange rate	5.7	5.5	-0.39	5.7	5.5	0.00
CRB**	572.3	583.7	0.08	-	-	0.00
Interest rate Selic (year-end)	11.25	11.75	-0.05	8.00	8.00	-0.10
Inflation expectations*	5.0	5.4	0.24	3.5	3.5	0.00
Inertia	-	-	0.00	-	-	0.07
Monitored price (II)	3.8	5.8	0.49	5.2	5.5	0.07
IPCA (I + II)	**4.7**	**5.0**	**0.34**	**3.2**	**3.2**	**0.0**

* Focus survey - reference period November 28th 2022

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

Electricity prices inflation: an important hypothesis that may change

In its base scenario, the BC assumes "red flag level 2" for electricity prices in December 2022. However, the hydrological outlook has improved markedly (see section above). Thus, the Copom may choose to change this hypothesis to "red flag 1" (XP scenario) or even to "yellow flag" - which is consistent to years with regular rainfalls. It that happens, the IPCA projections could decrease by 0 .37pp (red 1) or by 0.51pp (yellow).

Policy decision and Communication: becoming data-dependent

Considering the monetary adjustment already implemented and the current level of interest rates - already above what we consider the "neutral rate" - we expect the Copom to drop the signaling of another "adjustment of the same magnitude" after hiking the expected 150 pbs this week.

We believe it is the right thing to be done. Indeed, most of the monetary adjustment have not affected the economy yet, and global monetary policy is becoming less expansionary, helping to contain the "global part" of Brazilian inflation.

The challenge is not to sound "dovish". For that to happen, the Copom should open room for a different pace in March but reinforce that March decision is data dependent. Moreover, the Copom should keep the word "persistence" in the statement, indicating that even if the pace slows, rates will be kept high enough to ensure the convergence of inflation to the target path.

A possible wording of the policy paragraphs of the statement could be:

> The Committee considers that, given the increase in its inflation projections and in the risk of a deanchoring of long-term expectations, it is appropriate to advance the process of monetary tightening significantly into the restrictive territory. The Committee will persist in its strategy until the disinflation process and the expectation anchoring around its targets consolidate.
>
> For the next meeting, the Committee foresees ~~another adjustment of the same magnitude~~that the Selic rate will continue to advance into restrictive territory. The Copom emphasizes that its future policy steps ~~could be~~will be adjusted to ensure the convergence of inflation towards its targets and will depend on the evolution of economic activity, on the balance of risks, and on inflation expectations and projections for the relevant horizon for monetary policy.

Our view: approaching the "wait-and-see" moment

We have changed little in our view of monetary policy since the last Copom.

The challenge remains considerable. Consumer inflation continues to run well above the target path and there are still pressures at the wholesale level that could be passed through consumer prices.

We remain confident in the deceleration of inflation throughout the year. Domestic demand is already weakening, and the monetary adjustment already promoted by the Central Bank (BC) will still affected in the economy over the next year.

We have argued in our reports that tighter global monetary policy will help the BCB. Part of recent acceleration in Brazilian inflation is a global phenomenon.

In this sense, keep our scenario that Copom will reduce the pace of interest rate hikes to 0.75 pp in March, taking the Selic rate to 11.50%. We consider this contractionary level that, if maintained for a sufficiently long time, will produce the convergence of inflation to the target path in 2023.

Commodity prices and fiscal policy are the main risks. Commodities continue to rise despite singling of tighter global monetary policy ahead. If this movement continues and we see another year of rising commodities prices, IPCA disinflation will be more difficult. On the domestic side: the perception of increased fiscal risk may keep the exchange rate (and inflation expectations) under pressure.

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