Copom Warm-up

Growing challenges

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Highlights

- The data flow since the last Copom points to a worse outlook for inflation due to higher commodity prices, high current inflation and slightly better-than-expected economic activity.

- Our simulations replicating the Copom model suggest an increase in the IPCA projection for 2022 from 5.2% to 6.4% and from 3.2% to 3.4% for 2023 vis-à-vis the January meeting;

- We expect a 1.0pp increase in the Selic rate at this meeting. As we advance, considering the uncertainty generated by the war and the monetary tightening already implemented, we believe that it would be prudent for the Copom to leave the doors open for the next meeting instead of signaling another increase of the same magnitude.

Hawk-Dove Heatmap: It's getting worse all the time

Most information that came out since last Copom meeting, gathered in our "Hawk-dove Heatmap", point toward a worse inflation outlook.

First, commodity prices skyrocketed after Russia invaded Ukraine. CRB All-commodity Index growths 27% year-to-date. Some of the main drivers are products that have a direct impact on consumer price inflation, like Brent crude oil (51% YTD), corn (29% YTD) and wheat (41% YTD). It is still too soon to say that the higher prices will last for long. But, today, it represents a significant inflationary shock for world economy.

Second, most recent inflation readings continue to run at a quite elevated level. The average core measures from February IPCA stood at 1%, or an impressive 12% in annualized terms, the same level of January. There is no sign that the monetary tightening that the Central Bank has been implementing since March last year is slowing inflation down.

Third, economic activity figures suggest a somewhat better-than-expected final demand. 21Q4 GDP expanded by 0.5% in Q4 (1.6% YoY), roughly in line with our estimate (0.4% QoQ; 1.5% YoY) and above Street consensus (0.1% QoQ; 1.1% YoY). The domestic absorption grew 0.7pp in Q4 compared to Q3, with favorable figures from all components. In addition, January retail sales also came out slightly above expectations.

As a consequence of those factors, inflation expectations keep rising for 2022 and 2023 (see the Heatmap).

On the benign side, the exchange rate appreciated 7.3% since the last Copom meeting. Although not enough to offset the global commodity shock, it's is good news that the positive correlation between the BRL and commodity prices is back.

Finally, the level of water reservoirs increased markedly, confirming that electricity prices should fall throughout the year.

All in all, the Copom members are most likely even more worried about the inflation outlook in their last meeting.

Hawk-Dove Heatmap*

Variables	Aug-21	Sep-21	Oct-21	Dec-21	Jan-22	Mar-22	Comment
Exchange rate (Ptax)	5.2	5.3	5.6	5.7	5.4	5.0	Positive correlation with commodities is good news
Ex-ante real interest rate (%)	3.1	3.7	5.5	6.1	6.7	7.3	Significant increase, worse financial conditions
GDP 2021 Fcst (%, Focus)	2.1	1.6	1.4	0.5	0.3	0.5	Final demand a bit better
GDP 2022 Fcst (%, Focus)	2.5	2.2	2.0	1.9	1.5	1.4	Marginally worse
Output gap	-2.0	-1.8	-1.7	-1.7	-1.8	-1.7	Output gap should remain negative for longer
IPCA 12m (%)	8.4	9.7	10.3	10.7	10.1	10.5	Pressed and diffuse current inflation
Core IPCA annualized 3MMA	8.1	9.0	9.8	9.3	8.5	9.8	No relieve whatsoever
IGP-M 12m (%)	35.8	31.1	26.9	18.9	17.8	18.2	Additional cost pressure on the pipeline
IPCA 2022 Fcst (Focus, %)	3.81	4.10	4.4	5.2	5.4	6.5	Worsening, with the additional cost shock
IPCA 2023 Fcst (Focus, %)	3.25	3.25	3.3	3.5	3.5	3.7	Drifting away from the target
CDS 5y	178.0	196.9	227.4	222.2	213.1	223.4	Has stabilized at a relatively high level
Treasury 10y (%)	1.3	1.4	1.6	1.4	1.8	2.1	Higher rates ahead
Brent US$	76.3	75.3	86.2	71.9	89.9	111.0	At 14-year highs
CRB CMDT Index	562.2	555.5	568.3	568.8	584.0	628.0	Commodities rising across the board
Occupation of ICU beds	49.9	32.6	27.5	36.0	64.0	41.0	Normalizing
Deaths by Covid (mm7d)	987.0	532.0	337.0	214.0	627.0	653.5	Normalizing
Mobility index (Google)	-10.0	-7.0	-3.0	1.0	-6.0	-5.0	Normalizing
Reservoirs levels (%)	26.1	19.9	17.2	19.6	33.6	59.2	Electricity prices to fall this year

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

BCB model: Higher forecasts due to rising commodity prices and expectations

At the last Copom meeting, the inflation forecasts in the BCB base scenario were 5.4% for 2022 and 3.2% for 2023.

Since then, the median of Selic rate forecasts in the Focus survey rose from 11.25% to 12.75% in 2022 (end of period) and from 8.0% to 8.75% for 2023. The exchange rate strengthened to R$5.05/US$ from R$5.45/US$. Inflation expectations, also from BCB's Focus survey, edged up from 5,4% to 6,5% for 2022, and from 3.5 to 3,7% for 2023.

While tighter monetary policy and stronger FX contribute to reduce inflation forecast; rising inflation expectations and commodity prices act in the other direction. The net effect on market-price inflation in 2022 (75% of IPCA) is +0.64 pp (see table).

Regulated price inflation forecast (25% of IPCA) should also rise for this year - from 6.6% to 8.2% - due to the rise in oil prices, which significantly changes the Copom's fuel price forecast.

All considered, the IPCA forecast for 2022 in the baseline scenario should rise to 6.4% from 5.4%.

The forecast for 2023 also increase, but to a lesser extent since higher Selic rate trajectory offset part of the current inflationary shock. We believe the Copom's IPCA forecast for next year will increase to 3.4% from 3.2% in February.

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	5.9	0.64	2.5	2.5	0.00
Exchange rate	5.5	5.1	-0.73	5.5	5.1	-0.04
CRB	583.7	627.3	0.59	-	-	
Interest rate Selic (year-end)	11.8	12.8	-0.03	8.0	8.8	-0.30
Inflation expectations*	5.4	6.5	0.66	3.5	3.7	0.15
Inertia	-	-	0.00	-	-	0.19
Monitored price (II)	6.6	8.2	0.39	5.4	6.2	0.21
IPCA (I + II)	**5.4**	**6.4**	**1.0**	**3.2**	**3.4**	**0.2**

* Focus survey - reference period March 11st 2022

Policy decision and Communication: one, and on

We believe the Copom will hike the Selic rate by 1pp (100 bps) this week to 11.75%. It is a slower pace than in the previous two meetings, as explicitly signaled by the official communication. But it is still a historically significant step, especially considering that the policy rate is already at a contractionary level.

Considering the uncertainty created by the war and the already implemented monetary tightening, we believe it would be prudent for the Copom to leave doors open for the next meeting instead of signaling another hike of the same magnitude.

A possible wording for the post-meeting statement's policy paragraphs would be:

> Taking into account the reference scenario, the balance of risks, and the broad array of available information, the Copom unanimously decided to increase the Selic rate by 1.0~~5~~0 p.p. to 11~~0~~.75% p.a. The Committee judges that this decision reflects its reference scenario for prospective inflation, a higher-than-usual variance in the balance of risks and is consistent with the convergence of inflation to its target throughout the relevant horizon for monetary policy, which includes 2022 and, to a larger degree, 2023. Without compromising its fundamental objective of ensuring price stability, this decision also implies smoothing of economic fluctuations and fosters full employment.
>
> 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 keep advancing~~e~~ the process of monetary tightening significantly into the restrictive territory. The Committee emphasizes that it will persist in its strategy until the disinflation process and the expectation anchoring around its targets consolidate.
>
> For its next steps, the Committee foresees the monetary tightening cycle to continue. Considering the high geopolitical uncertainty, the pace will be adjusting according to how the economic scenario evolves ~~as adequate, at this moment, a reduction in the pace of adjustment of the interest rate. This indication reflects the stage of the tightening cycle as its cumulative effects will manifest themselves over the relevant horizon. The Copom emphasizes that its future policy steps could be adjusted~~ in order to ensure the convergence of inflation towards its targets, taking into account the stage of the tightening cycle ~~and will depend on the evolution of economic activity, on~~as well as the balance of risks~~, and~~ on inflation expectations and projections for the relevant horizon for monetary policy.

XP view: High interest rates for longer

We believe the war will not change Copom's flight plan regarding the terminal interest rate, even if this worsens the inflation outlook. We assess that the Selic rate is already at a quite restrictive level. Thus, the monetary authority is more likely to read it as a supply shock, accepting higher inflation for some time. We keep our forecast that the Selic rate will peak at 12.75%.

On the other hand, the renewed rise in costs should require greater persistence of monetary policy to ensure the convergence of inflation to the target path. We now believe that it will take longer for the BCB to find room for cut rates this year.

Naturally, **if the commodity shock proves to be more intense and prolonged** than that contemplated in our scenario - for example, we project an average price of Brent oil this year at 105 dollars a barrel, as described here - **the Copom may choose to go beyond of 12.75% this year.**

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