BRAZIL MACRO

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SCENARIO UPDATE

SURFING AN EXTENDED COMMODITY WAVE

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- **GLOBAL ECONOMY:** Faced with an inflationary environment — aggravated further by the conflict between Russia and Ukraine —advanced economies' central banks are starting to react in order to avoid an even more lasting inflationary cycle. In the U.S., the Federal Reserve (the Fed) has already started its monetary tightening cycle and should accelerate the pace of rate hikes at the next meeting. We expect the Fed to raise interest rates above neutral (estimated at 2.5%), to 3.0% in 2022 and 3.5% in 2023. In addition, the Fed is expected to reduce its balance sheet at a pace of US$95 billion per month. In the euro area, the European Central Bank (ECB) faces a more complex challenge. Mostly because of the significant reliance on energy imports from Russia, the conflict on the continent imposes an even stronger inflationary shock compared to other regions, also with adverse spillovers on activity. Confronting these uncertainties, the ECB has signaled a more hawkish drive, indicating that it would end asset purchases in June, while leaving the door open for rate hikes in 2H22. We expect the first increase in the ECB deposit rate to occur in 4Q22. In contrast, the People's Bank of China (PBoC) has been adopting a more dovish stance, adding stimulus to the economy in face of negative forces stemming from the lockdowns implemented to curb the pandemic. A combination of tighter global monetary conditions and the economic impact of the war in Eastern Europe generate headwinds for emerging market (EM) economies in general.
- **COMMODITIES:** Low inventories for most raw materials, coupled with idiosyncratic factors (e.g., adverse weather, past underinvestment, and high cost of production), have been feeding the commodity rally in 2022. The ongoing geopolitical shock coming from Eastern Europe aggravates further what was already materializing as supply-demand imbalances, given the additional supply disruptions caused by the war and economic sanctions imposed against Russia, ultimately reducing exports/supply from key producing countries for key commodities (e.g., grains, fuels, fertilizers). As a result, our commodity price forecasts have been revised upward for all indexes for 2022 and 2023. On average, we pencil in a double-digit increase in the path for the headline CRB Index and its key components, as compared to our previous scenario, suggesting an extended commodity cycle. While rising global interest rates and China's the zero-COVID policy could negatively affect commodity prices from the demand standpoint, we still see persistently high material costs on the heels of massive (and aggravating) supply constraints, with the disinflation process taking longer to occur. In our view, high commodity prices largely mitigate the impact of global headwinds on commodity-producing countries (case in point Brazil).
- **FX RATE:** The BRL rose nearly 18% against the USD in 1Q22, standing as the best-performing currency in a basket of 31 major currencies. We believe the BRL was favored by a combination of high interest rates (and differential versus global rates), rising commodity prices (being a key producer in most segments), and its (economic, political and geographical) distance from the epicenter of current geopolitical tensions. We continue to anticipate some BRL weakening from the current levels (~4.65 at the time of writing) in 2H22, owing to a sooner (and faster) normalization of monetary policies in advanced economies and a little volatility generated by the debate on future economic policy (2023 onward). However, we reckon that the upward shift in commodity prices and a shift in global EM asset allocation spurred by the Russia-Ukraine conflict, in tandem with a still significant interest rate differential, should result in a stronger-than-we-imagined BRL level. Hence, we are changing our forecasts for the USD/BRL cross to 5.00, 4.80 and 4.70 for YE2022, YE2023 and YE2024, respectively, from 5.40, 5.25 and 4.90 previously.
- **BALANCE OF PAYMENTS:** We expect the stronger path for the USD/BRL to prompt services and the primary income account to register higher deficits than previously forecast. However, higher commodity prices and a likely improvement in the terms of trade (vis-à-vis our previous scenario) should lead the trade balance to record more robust surpluses than we had previously calculated. We expect the latter impact (higher commodity prices) to prevail over the former (stronger FX rate); as such, we revised downward our current account deficit forecast to US$21.6 billion, US$19.5 billion and US$42.3 billion from US$22.7 billion, US$31.5 billion and US$62.6 billion for 2022, 2023 and 2024, respectively. With current account deficits at quite manageable levels (between 1-2% of GDP for 2022-2024) and abundant direct investment, we expect the balance of payments to remain a no-problem area for Brazil's economy in the foreseeable future.
- **FISCAL POLICY:** On the fiscal side, we now forecast a balanced primary budget for 2022 (previously: -0.8%), on the back of higher (mostly commodity-related) revenue. In our view, the central government should register a 0.5% of GDP primary deficit this year, offset by regional governments' 0.5% of GDP primary surplus. Our public-sector oil-revenue estimate has risen to 3.0% of GDP, from 2.6% in February, reflecting our current hypothesis for Brent oil prices (+27%, to US$115/bbl in terms of yearly

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average). We see a higher probability of fiscal stimulus via tax breaks ahead (with BRL50 billion already granted for 2022, in our estimates), with the increase in the income threshold of tax brackets for personal income tax expected to add BRL15 billion to the amount of revenue losses. Additionally, we continue to foresee a deterioration in the nominal (headline) budget results due to higher debt costs (in the Selic rate), implying a still steep upward trajectory for government debt in the medium term. Yet, in the short run, this nominal result will be partially offset by the BCB's profit from FX swaps in 2022 (currently above BRL80 billion), on the heels of the stronger BRL. We also updated our GDP deflator estimate to 9.5% (from 8.7%) this year, reflecting the higher commodity prices (and resulting inflation). In light of this, our 2022 gross-debt to GDP forecast was reduced to 80.6% (from 84.8%), remaining virtually stable compared to 2021. For the long term, since we assume the commodity cycle will, by definition, not be permanent, we continue to see a risky path toward debt stabilization, in a context of the reduced efficacy of fiscal rules, and the social pressures to increase expenditures in a context of higher inflation. Despite the breathing room on the fiscal side provided by this extended commodity cycle, the high level of mandatory expenses is a problem that needs fixing as soon as possible (via economic reforms) in order to quell the fiscal risks in the medium to long run.

- **ECONOMIC ACTIVITY – CORE:** We are maintaining our GDP growth forecasts for the 2022-2024 horizon. For 2022, our estimate is 0.7%, supported by the consolidation of the services sector reopening, the expansion in the real wage bill (a byproduct of the jobs recovery), and the strengthening in less cyclical commodity-related sectors (likely to see additional boost after the recent price developments). We expect these factors to prevail in 1H22, though we think they are likely to be offset by the delayed effects of a tight monetary policy in 2H22 (and onward). For 2023, a retreat in real GDP and, owing to an even higher terminal Selic level in 2022, we are lowering slightly our 2023 GDP estimate to -0.3% (from -0.2%). Regarding the impacts of the Russian-Ukrainian conflict on activity, the low share of Brazilian trade with these countries suggests a mild direct impact (via external demand), but the rising prices resulting from the conflict could weigh on consumption and this year (also indirectly via the monetary policy channel). Yet we believe that these effects are to be somehow mitigated by an additional impulse from commodity-related sectors, which are expected to benefit from higher material prices.

- **ECONOMIC ACTIVITY – LABOR MARKET:** The latest batch of job numbers led us to reduce our 2022 average unemployment rate forecast, especially due to the impact of the outbreak of the Omicron variant. According to our monthly employment data estimates, the wave of infections sparked rapid shrinkage in both the labor force and the employed population in January, though both recovered somewhat in February. This led the participation rate, which was already running historically low, to return to a slight downward trajectory at the margin. As a result, the unemployment rate has fallen even further and now hovers close to 11% — below our expectations. We still expect the unemployment rate to rise toward 14% in 2H22, reflecting an upsurge in the working population, a catch-up for the participation rate (toward the historical average, given the improved prognosis for Covid owing to the country's high vaccination rates), and the stalling of job creation. However, 1Q22's lower unemployment rate and the slower participation rate recovery led us to reduce our average unemployment rate forecast for 2022 to 12.7% (from 13.3%). We maintain our forecast for average unemployment at 14.0% for 2023. We acknowledge the risk of a lower joblessness rate in both 2022 and 2023 if the participation rate fails to return to pre-crisis levels.

- **INFLATION:** The impact of the Russia- Ukraine conflict on commodity prices led to another round of upward pressure (and surprises) on IPCA inflation, despite the partial cushioning from the BRL appreciation. On top of that, the war has further aggravated ongoing supply chain disruptions. As a result, the IPCA 2022 forecast was revised from 6.0% to 7.9%, with the main drivers of the revision being food-at-home, industrial goods and fuels. The IPCA 2023 forecast was also revised upward—from 3.7% to 4.0%, mainly due to the inertial effects of a higher IPCA 2022. In general, we are still confident that volatile items (particularly the ones related to "imported inflation") will generate headline inflation's peak in May 2022, but the main risk we see comes from services inflation. This new round of shocks can make inflation even stickier in this sector that is already considerably inertial, so it could turn the disinflation process even slower, especially for 2023. For the IPCA 2024, we see a convergence to the target, on the back of a really tight policy stance, especially around 4Q22 and 1Q23.

- **MONETARY POLICY:** In the last policy meeting (March 15-16), the Brazilian Central Bank (BCB) sent a message to the markets that the authority's flight plan is to deliver a final rate hike of 100 bps in the next Copom meeting (May 3-4), ending the cycle at 12.75%. The plan seems to follow the BCB's view, based on its model simulations, that IPCA inflation would converge to the mid-target in 2023 with this monetary policy dosage, even considering the upwardly skewed balance of risks (whose bias seems to have diminished, in the BCB's assessment). Such results seem to have been influenced by the forecast of an even higher Selic path throughout 2023, reflecting the deteriorating inflation outlook in the aftermath of the Russian invasion and its economic consequences. The BCB recognizes the high degree of uncertainties and does not close door on the possibility of further adjustments (i.e., an even tighter policy stance) if conditions worsen. In our view, despite good clarity on the BCB's flight plan (to end the cycle at 12.75%), inflation expectations for 2023 may continue to rise a bit in the coming weeks, before eventually stabilizing. Thus, we continue to think the BCB may be led to revise the current plan, and that may be particularly true after the discomforting numbers from March IPCA. Our Selic rate forecast includes a hike of 100 bps in May (to 12.75%) and a last move of 50 bps (to 13.25%) in June. Looking further ahead, we expect a tight(er) policy stance for long(er): we forecast rate cuts to start only in March 2023, with the Selic reaching 10.00% at YE2023 and the neutral level of 7.00% only in 2024. The current cycle is to lead to the tightest policy stance since 2009 (when our series begin).

Figure 1. Santander Brazil's Global Macro Assumptions – Summary

Global Macro Backdrop	2018	2019	2020	2021	2022E	2023E	2024E
Global GDP (%)	3.5	2.8	-3.5	5.9	3.7	3.0	3.0
China GDP (%)	6.7	6.0	2.3	8.1	5.2	5.0	5.0
US GDP (%)	3.0	2.2	-3.5	5.7	3.5	2.0	1.5
US Inflation (CPI, %)	1.9	2.3	1.4	4.7	6.5	2.8	2.3
US Interest Rate (FFR, %)	2.50	1.75	0.25	0.25	3.00	3.50	3.50
US Interest Rate (UST10y, %)	2.7	1.9	0.8	1.8	3.1	3.8	3.0
Dollar Index - DXY	96	96	90	96	101	100	100
Commodity Prices - CRB	409	401	444	571	606	569	502

Source: Bloombnerg, Santander estimates.

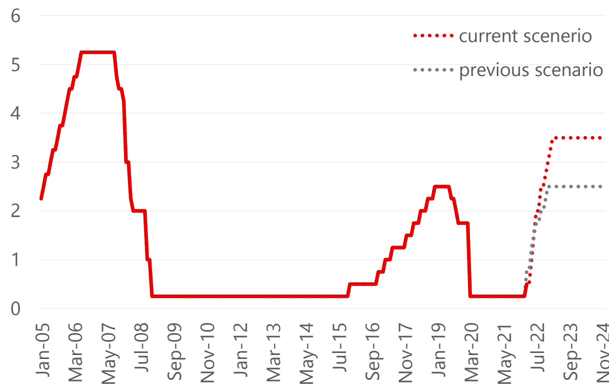
Figure 2. Santander Macro Forecasts for Brazil – Summary

Macroeconomic Variables		Previous	Current
GDP (%)	2022E	0.7	0.7
	2023E	-0.2	-0.3
	2024E	1.5	1.5
IPCA (%)	2022E	6.0	7.9
	2023E	3.7	4.0
	2024E	3.0	3.0
Selic Rate (% end of period)	2022E	12.50	13.25
	2023E	9.00	10.00
	2024E	7.00	7.00
FX Rate - USDBRL (end of period)	2022E	5.40	5.00
	2023E	5.25	4.80
	2024E	4.90	4.70
Current Account Balance (% of GDP)	2022E	-1.4	-1.2
	2023E	-1.8	-1.0
	2024E	-3.2	-2.0
Primary Fiscal Balance (% of GDP)	2022E	-0.8	0.0
	2023E	-1.1	-0.8
	2024E	-0.9	-0.6
Gross Public Debt (% of GDP)	2022E	84.8	80.6
	2023E	89.0	84.1
	2024E	92.2	87.5

Source: Santander estimates.

GLOBAL ECONOMY

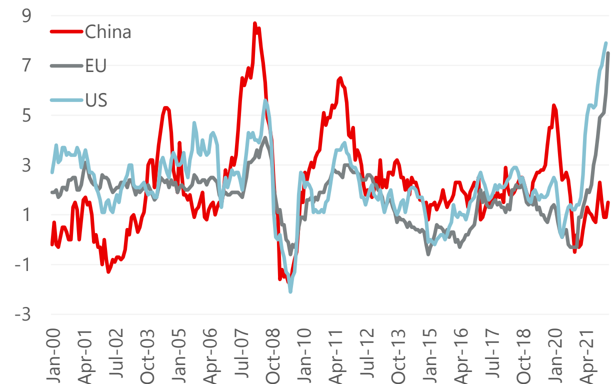
Figure 3. Fed Funds: Historical and Expected Path



Sources: Bloomberg, Santander.

GLOBAL ECONOMY

Figure 4. CPI Trends in the Largest Economies



Sources: Bloomberg, Santander.

COMMODITIES

Figure 5. Historical Path and Forecasts for CRB Index

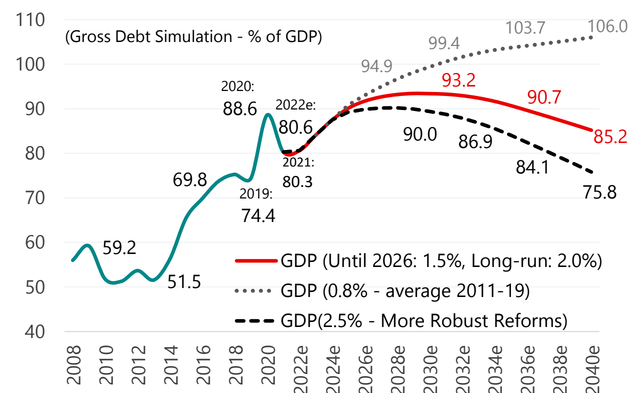
YE	2019	2020	2021	2022e	2023e
CRB Food	331	355	483	542 ↑	488 ↑
CRB Energy	1647	1161	1521	1850 ↑	1809 ↑
CRB Metal	749	887	1259	1306 ↑	1171 ↑
CRB	401	444	571	606 ↑	570 ↑

YE YoY	2019	2020	2021	2022e	2023e
CRB Food	1%	7%	36%	12%	-10%
CRB Energy	2%	-30%	31%	22%	-2%
CRB Metal	-11%	18%	42%	4%	-10%
CRB	-3%	11%	29%	6%	-6%

Sources: Bloomberg, Santander.

FISCAL POLICY

Figure 6. Better Short Term, Still Challenging Outlook



Sources: Brazilian Central Bank, Santander.

BALANCE OF PAYMENTS

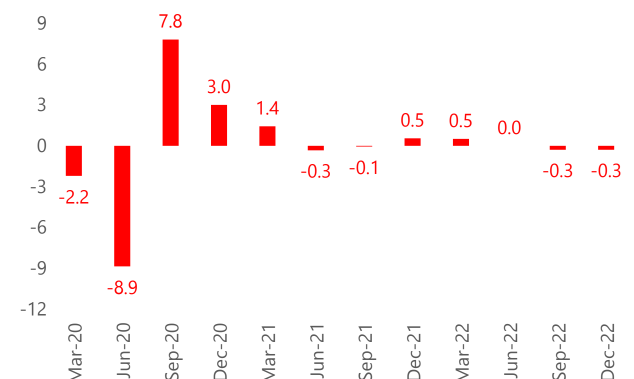
Figure 7. Current Account Balance (% of GDP)

% of GDP	2020	2021	2022e	2023e	2024e
Current account balance	-1.7	-1.9	-1.2	-1.0	-2.0
Trade balance	2.2	2.4	3.5	3.4	2.4
Exports	14.6	18.8	17.9	17.4	16.4
Imports	12.3	16.4	14.4	14.0	14.1
Services	-1.4	-1.1	-1.6	-1.5	-1.5
Tourism	-0.2	-0.2	-0.5	-0.5	-0.6
Eq. Rental	-0.8	-0.5	-0.5	-0.4	-0.4
Others	-0.5	-0.5	-0.6	-0.5	-0.5
Income	-2.6	-3.4	-3.3	-3.1	-3.1
Profits & Dividends	-1.2	-2.0	-2.3	-2.2	-2.3
Interest payments	-1.5	-1.4	-1.0	-0.9	-0.8
Transfers	0.2	0.2	0.1	0.2	0.2
Direct investment onshore	2.6	3.1	3.8	3.6	3.5
External funding (-ve=shortage / +ve=excess)	0.9	1.2	2.6	2.6	1.5

Sources: Brazilian Central Bank, Santander.

ECONOMIC ACTIVITY—CORE

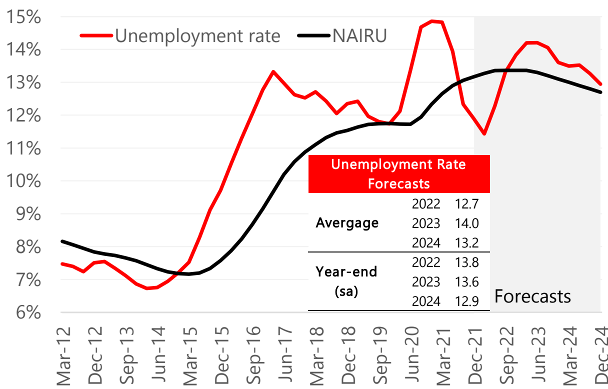
Figure 8. GDP Growth (QoQ-sa, %)



Sources: IBGE, Santander. Santander estimates for 1Q22 onwards.

ECONOMIC ACTIVITY—EMPLOYMENT

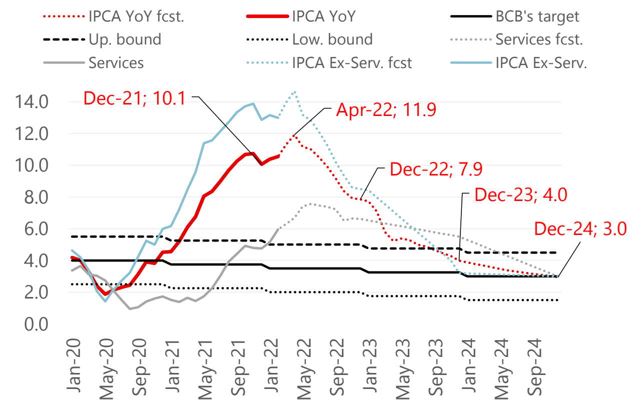
Figure 9. Unemployment Rate and the NAIRU (sa)



Sources: IBGE, Santander.

INFLATION

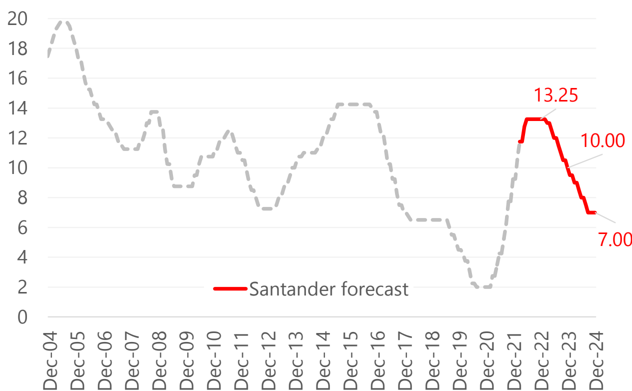
Figure 10. IPCA Inflation, Key Components (% YoY)



Sources: IBGE, Brazilian Central Bank, Santander

MONETARY POLICY

Figure 11. Historical, Expected Selic Rate Path (% p.a.)

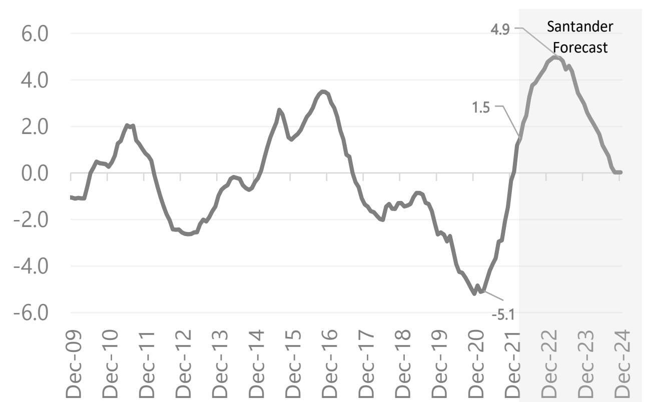


Note: Historical data in monthly averages; projections for year-end Selic

Sources: Brazilian Central Bank, Santander.

MONETARY POLICY

Figure 12. Historical, Expected Policy Stance (% p.a.)



Note: Real "ex-ante" policy rate (Selic deflated by median 12-month forward IPCA forecasts) minus our "asset-based" neutral rate proxy (5y5y forwards discounted by a historical risk premium).

Sources: Brazilian Central Bank, Santander.

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