



# Brazil Macro Monthly

Year ends on a good note,  
challenges for 2021 remain

December 2020

## Brazil Macro Monthly: Year ends on a good note, challenges for 2021 remain

- The year is ending on a good note. The spending ceiling remains intact and the risk premium on Brazilian assets subsided. The National Treasury funding conditions have improved, reducing short-term financial risk.
- But risks persist. Covid's numbers have worsened and there is still no clear scenario for vaccination. The pressure for fiscal spending is expected to remain high in 2021.
- Our forecasts for most economic variables remain the same (see table below). We improved our numbers for primary-deficit/GDP and for the gross-debt/GDP, due to better revenue figures and the upward revision of nominal GDP by IBGE.
- The Copom signaled it may remove the Forward Guidance soon, as inflation expectation is nearing the target path. Still, we believe there will be no rush to raise the Selic rate, given the likely slowdown in the economy and the temporary nature of the current inflationary shock.

<b>XP Forecasts</b>				
	<b>2018</b>	<b>2019</b>	<b>2020 (E)</b>	<b>2021 (E)</b>
GDP growth (%)	1.3	1.1	-4.6	3.4
Unemployment rate (% s.a., end of period)	12.2	11.5	15.1	14.5
IPCA (CPI, 12m, %)	3.75	4.31	4.5	3.5
SELIC rate (% p.y., end of period)	6.50	4.50	2.0	3.0
FX (USDBRL, end of period)	3.87	4.03	5.20	4.90
Primary fiscal deficit (% GDP)	1.6	0.9	11.3	3.0
Gross debt (% GDP)	76.5	75.8	90.9	91.6
Trade Balance (USD Bn)	59.8	48.0	60.0	71.0
Exports (USD Bn)	241.0	225.4	205.0	229.0
Imports (USD Bn)	181.2	177.4	145.0	158.0

Source: IBGE, BCB, Bloomberg. Estimates (E): XP Investimentos.

### Foreword: Can't Relax

The year is ending on a good note for the Brazilian economy. In line with our baseline scenario, the spending ceiling was maintained and the risk premium on Brazilian assets receded. The economy continues to recover, albeit at a somewhat slower pace. China's strong recovery, which boost commodity prices, also helps.

The rise of inflation deserves attention, but there are elements to consider it temporary. The BCB should start normalizing monetary policy early next year by removing the Forward Guidance, but there is no rush to raise the Selic Rate.

Uncertainties, however, remain. Especially on the activity side, with the withdrawal of government programs and the persistence of worrying numbers of the pandemic. A clear vaccination plan is essential, as is the case in other countries.

The fiscal risks also continue. As we wrote in this space last month, it is important to take advantage of the first semester's window of opportunity to move forward with the Legislative agenda. Spending pressures will be intense, particularly in the second half. The fiscal triggers contemplated in the Emergency Bill will be critical to shield the fiscal framework.

## The International Background: Strong China is good news for Latam

If the vaccination effort works as expected (our base case scenario), we think that by the second half of 2021 the world will be much closer to normality

Our in-house models are indicating that the **US economy** is set to contract 3.5% in 2020, but also that it could feasibly expand north of 5% in 2021. We expect 2021 growth to be boosted by the deployment of speedy vaccination processes, ones that will most likely coexist with increased fiscal stimulus and a lingering very accommodative monetary policy stance.

In Europe, the speed of the recovery is likely to lag the one in the US, as less “creative destruction” took place in the Eurozone during the pandemic –as governments decided to shield employment with more zeal compared to the US. We expect Europe to print negative sequential growth in Q420, but we are becoming a bit more positive concerning Q121, as the second wave of the pandemic seems to be peaking.

Regarding **China**, our models are showing that the economy is, plainly speaking, “roaring back”, and that it is highly likely that this country will be growing materially above potential in 2021. We see the Chinese economy expanding 1.8% in 2020 and an impressive 8.5% next year. We expect investment to prove to be the main component of the growth equation in 2021. On the FX front, we see the USDCNY trading at 6.30 by year-end 2021.

The outlook is benign for **Latin America**. The US Senate in Republican hands is positive, as US tax policy will most likely remain stable, monetary policy should not change, and anti-outsourcing sentiment should remain relatively constrained. It is almost certain that a very effective vaccine will be available for the Latam region in the short-term. Higher commodity prices are also good news. We expect WTI prices to increase further in 2021 and to finish the year at \$60, as demand for land, water and air transportation rebounds, and non-conventional supply remains relatively constrained compared to pre-pandemic levels. The impressive jump in Chinese growth will also help support soft commodity and metal prices.

In this scenario, we see further room for Latam currencies to strengthen.

## Brazil: Year ends on a good note, challenges remain

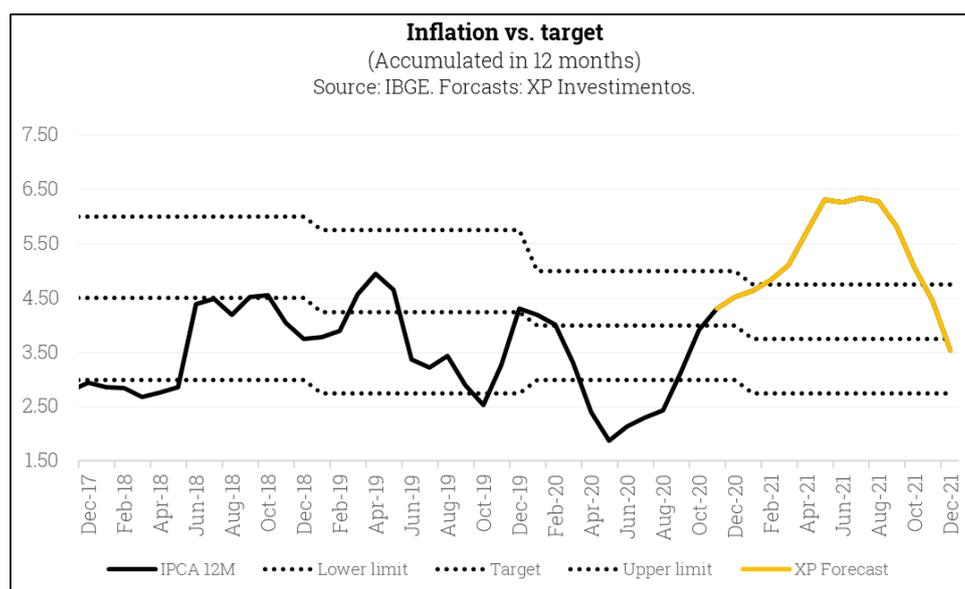
### Inflation remains under pressure; some relieve expected ahead

Current inflation remains under pressure. November IPCA was higher than market expectations. YoY IPCA has reached 4.31% (2.1% in June). This pressure is caused mostly by the rise in international food prices, by the mismatch between supply and demand in the domestic durable goods markets, and by some margin rebuild in services sector.

However, there are some reasons to believe inflation will recede in 2021. The recent FX appreciation eases external pressures. The end of emergency programs contributes to slow domestic demand, while supply has been showing signs of normalization.

Our understanding is that the YoY IPCA will continue to rise, exceeding 6% by mid-next year, before starts to decline, as the high figures of the end of this year come out of the statistics.

We expect the IPCA at 4.5% in 2020 and 3.5% in 2021.

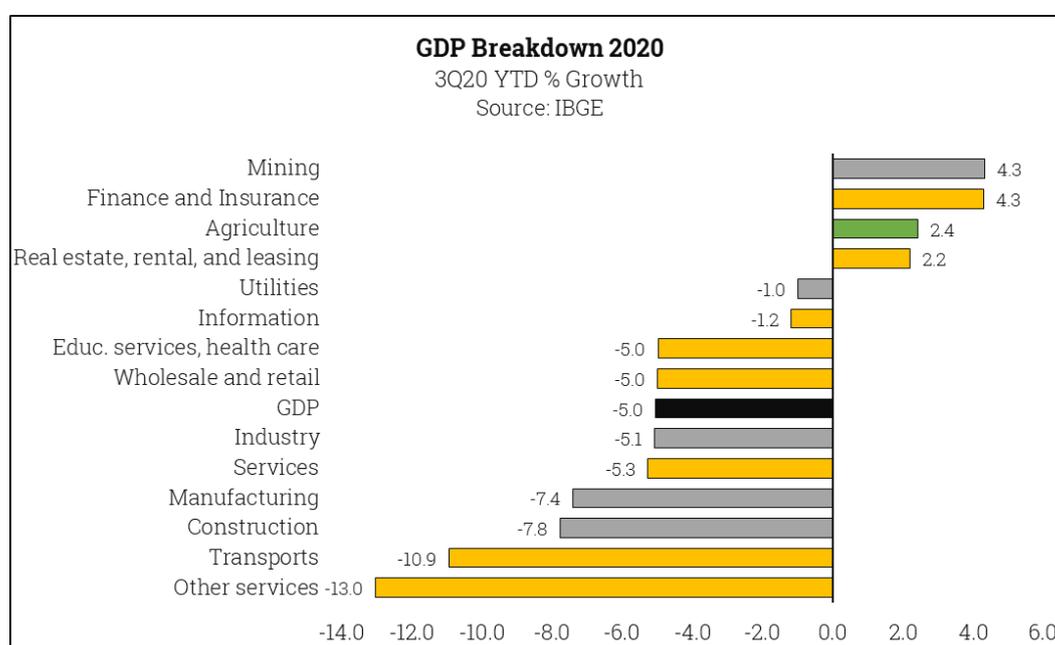


## Ongoing Recovery

The third quarter GDP grew 7.7% over the second quarter, suggesting that the recovery continues at a good pace. For the fourth quarter, we expect another positive, albeit more modest (or, say, more normal) figure: 1.6%. Industrial production, retail sales and services showed positive month-over-month numbers in October.

The pace of economic recovery will depend on the effects of the pandemic on the service sector. This share of GDP, which represents 52.1% of the total output, is still -6.2% below pre-pandemic levels. Total GDP is 4.1% below, supported by manufacturing and commerce. In addition, services were responsible for more than 52.0% of jobs before the pandemic, what reveals the importance of these activities for the economic cycle. Recent job-creation figures in the service sector are positive, but still relatively weak.

This uneven recovery among sectors is contemplated in our scenario. We maintain our GDP forecasts at -4.6% for 2020 and 3.4% for 2021. It is worth remembering that the statistical carry-over for the next year stands at + 2.3%.



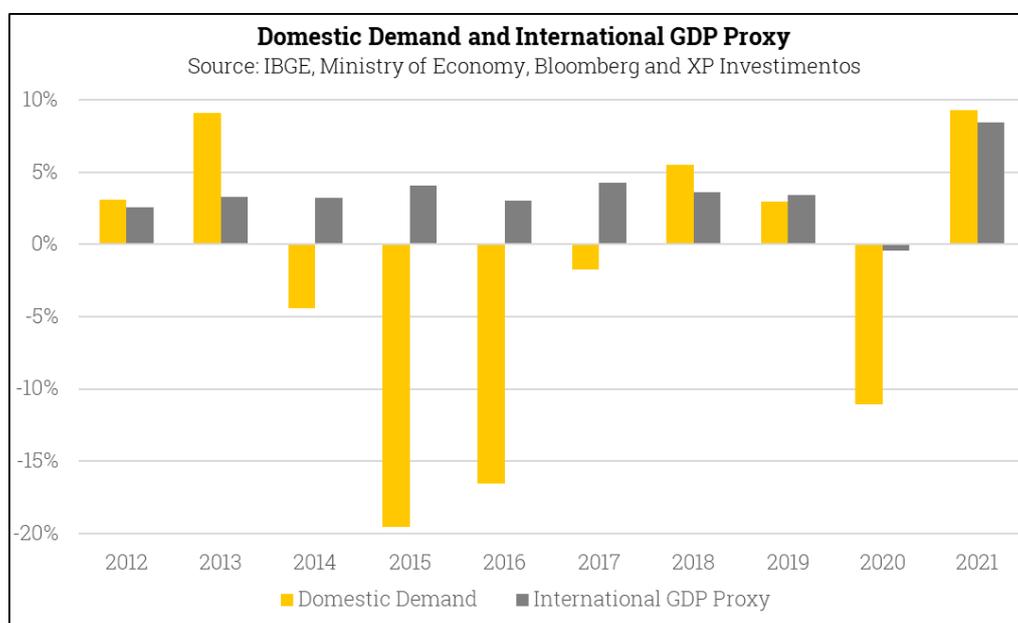
## Larger trade surplus in 2021, Brazilian Real realigning with its fundamentals

Until November, the Brazilian trade balance accumulates a surplus of US\$ 51 billion, US\$ 8.9 billion above the same period in 2019. The improvement is the result of a greater decrease in imports (US\$ -24.3 billion) than in exports (US\$ -15.3 bi).

Exports fell due to the price effect. The exported quantum remained relatively stable during the pandemic, while prices fell sharply in the first half of the year and have been recovering partially since July. The positive highlights were agriculture and mining sectors. Goods with higher added value, in turn, performed negatively in the year, when compared to 2019.

Regarding the destination of these exports, China stands out: US\$ 5.4 billion more than in the same period of 2019. China's relative relevance increased: the country absorbed 33% of our exports in the first eleven months of 2020, compared to 28% in the same period last year.

For 2020, we expect the trade balance to be close to USD 60 billion. For next year, the balance is expected to rise to USD 70 billion. In our view, both exports and imports will recover next year. On the import side, domestic demand rebound will spur demand for industrial inputs; and for durable and semi-durable goods. On the export side, we calculate an international GDP proxy, weighted by the importance of the main Brazilian trading partners. Driven by China, it indicates a significant increase in the quantum exported next year. Demand from the Eurozone, the United States and Argentina, is also expected to recover. The real exchange rate still undervalued (even with the recent movement) and favorable international commodity prices complete the positive picture for Brazilian exports.



### *The Brazilian Real appreciates, realigning with its fundamentals*

November was a positive month for emerging currencies, especially for the Real. The Brazilian currency appreciated 10.2%, topping the global ranking. Among the factors that boosted the Real are the reduction in the perception of fiscal risk, the acceleration of commodity prices (especially iron ore), and the anticipation of the rollover of Swaps maturing in January by the Central Bank. The maneuver that started in the middle of November was accentuated on the last day of the month with an increase in the supply of contracts aiming to meet the demand for the Real expected by the dismantling of the overhedge from the financial institutions. In this scenario, we continue to see the exchange rate at 4.9 reais per dollar in 2021, with the potential for further appreciation if the global scenario continues to suggest the weaker dollar against emerging currencies.

## Fiscal: framework preserved, good management and a little help from nominal GDP

Results of public accounts have been better than expected. On the one hand, spending to fight the pandemic continues to weigh on the government's primary budget, albeit gradually less so as we approach the end of the year. On the other hand, we see a strong resumption in tax collection, especially in states and municipalities.

There is also some relief coming from non-Covid spending. A total of R\$ 11.0 billion reserved for Bolsa Família on this year's budget won't be used, given most recipients were registered for the covid-19 emergency assistance (accounted for in the War Budget). By the same token, social security expenses are expected to end the year approximately R\$ 7.0 billion below budget, as a result of last year's reform.

In this context, we revised our 2020 projections of primary deficit from 12.8% of GDP to 11.3% and of Gross Debt / GDP from 94.4% to 90.9%. The selling of international reserves by the Central Bank and the upwards revision of nominal GDP by the IBGE(1) also contributed to the improvement of projections, pushing the debt a bit further away from the psychological barrier of 100% of GDP.

For 2021, we project a primary deficit of 3.0% of GDP, and Gross Debt / GDP at 91.6%.

*Respect to the spending ceiling and external scenario improve liquidity conditions for National Treasury*

Benefiting from a scenario of relative easing of short term market stress, boosted by positive winds coming from the external environment, the National Treasury successfully raised R\$ 286 billion in public securities in the domestic market between November and December(2) - at relatively lower rates and longer tenures.

The total issued is more than enough for the rollover of R\$ 140.2 billion in bonds maturing until January 2021. Considering the deficit of approximately R\$ 240 billion expected for the period, it is also worth highlighting the R\$ 767 billion calculated as a proxy for the liquidity cushion currently available for Treasury's debt management.

*Fiscal risk remains high to 2021*

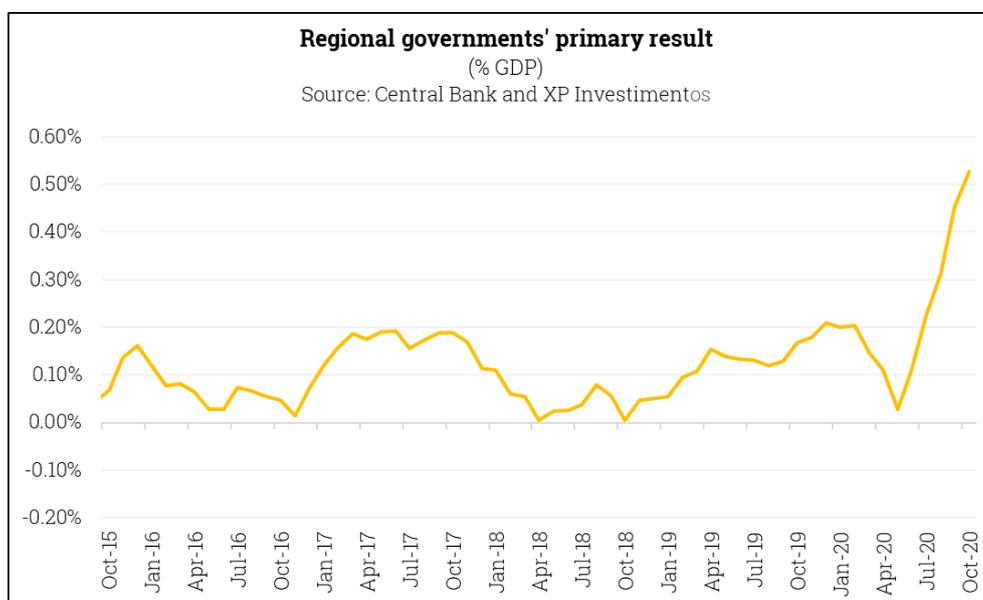
Despite the more positive short-term scenario, key challenges remain for 2021. The impact of current inflation pressure on mandatory spending linked to the minimum wage, mentioned in our previous Monthly Report, should now reach R\$ 20.7 billion in additional mandatory spending for next year(3).

(1) Following IBGE's methodological change, the projection of nominal GDP rose to R\$ 7.34 trillion in 2020 (from R\$ 7.16 trillion) and to R\$ 7.92 trillion in 2021 (from R\$ 7.26 trillion). This led to a revision of DBGG / GDP projection from 93.1% to 90.9% in 2020 and from 94.2% to 91.6% in 2021.

(2) Total issuance by the Treasury between November 1st and December 10th.

(3) Projection of 4.8% for INPC in December (accumulated in twelve months).

In this context, the approval of the triggers that protect the spending ceiling in 2021 is of essence. The Emergency Constitutional Amendment report has been postponed until next year. It will now be key to take advantage of the short-term window of opportunity, backed by favorable market conditions, to improve the details of the proposal, and approve it as soon as early next year.



## Copom: no hurry to hike rates

The Monetary Policy Committee of the Central Bank of Brazil - Copom - signaled at its last meeting that it may remove the forward guidance, implemented in its August meeting.

It makes sense, in our view. The inflation forecasts for 2021 and 2022 - both market participant's and the Copom's - are no longer too far from the target path.

The instrument was implemented when inflation expectations were falling, drifting away from the target. This is no longer the case. As Copom acknowledged: "the conditions for maintaining the forward guidance may soon no longer apply".

Without the guidance, monetary policy will follow the ordinary inflation target framework. In this sense, we understand that there will be no rush to raise the Selic rate. The current inflationary shock tends to be temporary; unemployment will remain high throughout the year; and monetary policy will play a greater role in sustaining the economic recovery with the withdrawal of fiscal emergency programs.

Thus, we keep our scenario - which we hold since June - that the Copom will start hiking the Selic rate in the second half of 2021, up to 3% at the end of the year.

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