



Brazil Macro Monthly

2022 scenario depends on
2021 advances

January 2021

Brazil Macro Monthly: 2022 scenario depends on 2021 advances

- External factors and domestic risk put pressure on the Brazilian exchange rate at the beginning of the year. We understand that the fundamentals still suggest a stronger FX. We projected 4.9 reais to the dollar in 2021 and 4.8 in 2022.
- The end of emergency programs should curb domestic demand. Still, recovering labor market, low interest rates and - later on - the vaccine, should keep growth on positive territory.
- Stronger real and tighter fiscal policy give room to the Copom to keep the Selic rate at 2% for now. We forecast that the hiking cycle should start in August, and continue in 2022 until the Selic rate reaches 4%.
- Fiscal outlook remain risky, even with the inflation dynamics helping the Government to comply with the spending cap next year. Progressing with the reform agenda is crucial to ensure a balanced scenario in 2022 and beyond.

XP Forecasts

	2018	2019	2020	2021 (F)	2022 (F)
GDP growth (%)	1.3	1.1	-4.6	3.4	2.0
Unemployment rate (% s.a., end of period)	12.2	11.5	14.7	14.6	11.8
IPCA (CPI, 12m, %)	3.8	4.3	4.5	3.5	3.4
SELIC rate (% p.y., end of period)	6.5	4.5	2.0	3.0	4.0
FX (USDBRL, end of period)	3.9	4.0	5.2	4.9	4.8
Primary fiscal balance (% GDP)	-1.6	-0.9	-10.7	-3.1	-2.3
Gross debt (% GDP)	76.5	75.8	90.2	91.0	92.3
Trade Balance (USD Bn)	59.8	48.0	50.9	74	64
Exports (USD Bn)	241.0	225.4	209.8	259	267.0
Imports (USD Bn)	181.2	177.4	158.9	184	203

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

Foreword: 2022 on the horizon

Rising inflation expectations and the troubled political environment in the United States put pressure on the US Treasury rates. Even at historically low levels, the dynamics affect emerging market currencies. The sharp rise in commodity prices, driven by the sound pace of the global industry, did not softened the movement.

In the case of Brazil, the currency also suffers from political uncertainties driven by the upcoming elections in the legislative houses, particularly in the Lower House. There are also questions on government's capacity to approve reforms, such as the Emergency Constitutional Amendment (PEC).

These factors seem temporary to us. We continue to see low interest rates and a weakening dollar trend in the world. Despite political pressure, we do not expect changes in the Brazilian fiscal regime. Against this background, the Real is expected to appreciate - we keep our forecast at 4.90 reals per dollar at the end of this year - reducing local inflationary pressures. The slowdown in aggregate demand, noticeable even before the end of the emergency aid, reinforces this scenario, providing some room for the Central Bank to keep the Selic rate at 2.00% throughout the first half of 2021.

However, we should not overlook the risk of an extended "hump" of inflation, what may spur inflation expectations. In our report from November last year, we argued that inflation expectations in Brazil, even for longer terms, are correlated with current inflation ([click here to access the report](#)).

This month, we introduce our scenario for 2022. It will be easier to comply with fiscal rules considering the increase in the spending ceiling due pressures on current inflation, but uncertain from the political perspective. We understand that, with Covid under control, the world should continue to grow. Brazil may grow by 2.0%, with inflation close to the target (3.4%) and the exchange rate marginally appreciated compared to 2021 (4.80 reals per dollar). The normalization of monetary policy that should start this year should be prolonged until the Selic reaches 4.00% by mid-2022.

For this relatively balanced scenario to be confirmed, it is important to move forward with the fiscal reform agenda this year. If it is true that it will be easier to comply with the ceiling in 2022, the dynamics thereafter remain complex. Especially with the debt / GDP ratio above 90%.

Global Outlook: UST yields to go up a bit more

We believe that the democrats holding a slim majority in the Senate will allow President-elect Biden to quickly confirm his cabinet team. Also, controlling the Senate means that Biden will have a freer hand to ensure the approval of a larger stimulus package. But, contrary to some market views, we believe the slim majority will not mean much more than that.

On growth, our models suggest US economy expanded at a 7% sequential annualized rate during the fourth quarter of last year. Such robust performance is a very positive sign to what is to come on the growth and earnings front, not least because the rate of new Sars-Cov2 infections during Q420 was already reaching alarming levels. We believe that the bearish jobs print of December will prove to be an outlier.

Underlying inflation is set to accelerate during the first half of 2021, due to base effect, higher commodity prices and a lower future incidence of the pandemic thanks to the aggressive vaccination. Still, we do not see inflation creeping up consistently. Our models show that the output gap is unlikely to close before 2023, and that there's virtually zero risk of the employment gap being closed before 2025.

We think that the rise in inflation will continue to add pressure to benchmark fixed income instruments. We now see the US 10-year ending 2021 yielding 1.3% (1.1% before). We expect the Fed to react decisively to shield the ongoing economic expansion and the health of the housing market if, at some point during the year, fixed income markets start to evidence a behavior that resembles the "taper tantrum" of 2013. We believe that the Fed's policy of choice under such circumstances would be to implement a yield-curve-control strategy.

In Europe, we do not expect any changes to ECB's monetary policy at this month's meeting, following the set of easing measures announced last December. However, we still think that the risk remains for the ECB to deliver additional measures in 2021 on the back of stubbornly low inflation, which should help core sovereign yields to remain close to current record lows, with the 10-year Bund trading below -0.50% by the end of 2021, while we see room for spread compression for peripheral sovereign yields.

Regarding China, high-frequency data remain quite robust. We see China expanding 1.8% in 2020 and an impressive 9% in 2021. We expect investment to prove to be the main component of the growth equation in 2021, with fixed urban investment continuing its acceleration path and ending the year with growth rates of more than 10%.

We reiterate our long-standing view that the degree of animosity that currently exists between the US and China will fall under a Biden administration, as the relationship will go from being managed via Twitter to being addressed through the conventional diplomatic channels. Still, we don't expect to see a review of the current tariff structure. We see the Yuan trading at 6.30 to the US Dollar by 2021 year-end.

Brazil: 2022 scenario depends on 2021 advances

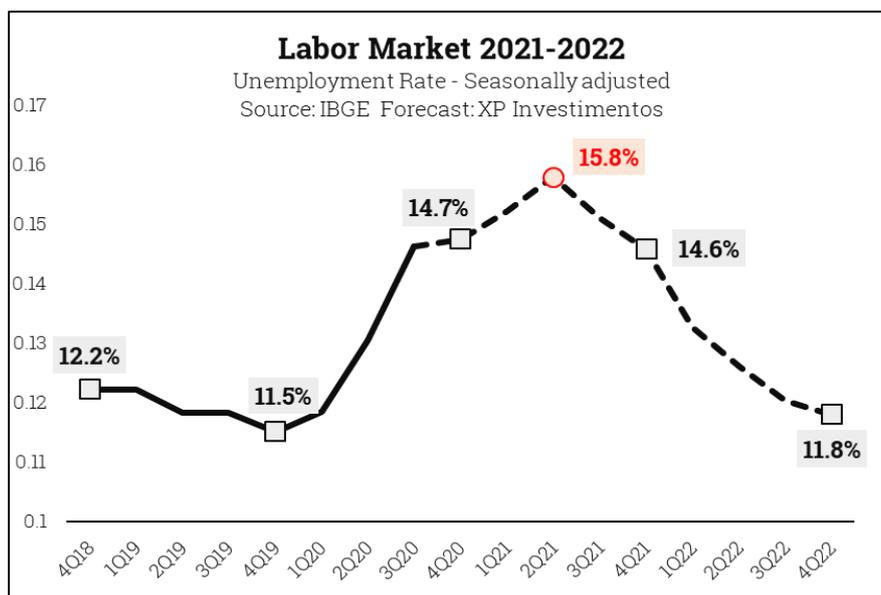
Continuity of the recovery relies on the labor market

The picture of the Brazilian economy seen throughout the pandemic should remain the same at the start of 2021: the strong manufacturing performance contrasting to the sluggishness seen in the services sector. Leading industrial indicators such as NUCI-FGV and ABCR-Heavy suggest some accommodation in December. However, as inventories are still low, we may still witness increased production levels even with weaker retail dynamics.

We believe that the major source of uncertainty remains in the service sector (PMS), which until the last reading in November was 3.2% below pre-pandemic levels. The circumstantial and precautionary savings build during the pandemics may help to cross the first months of 2021, but the vaccination plan will be crucial for the sector's trajectory in the coming quarters.

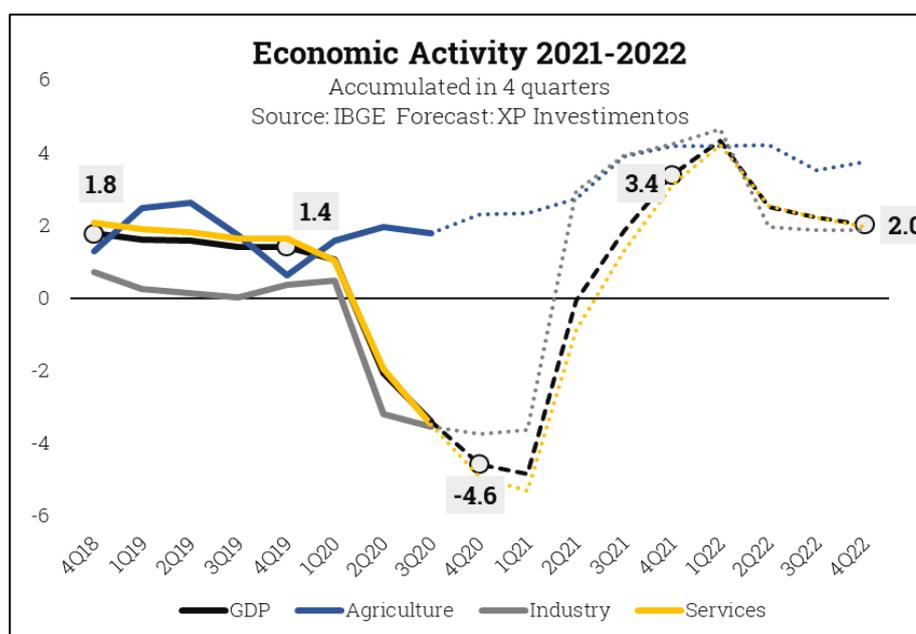
From the demand perspective, with the government's emergency aid coming to an end, the labor market will play a key role in the recovery of activity during the first half of 2021. The PNAD survey showed a 8% recovery in labor income between October and July. Additionally, CAGED should end 2020 with the creation of 150 thousand jobs.

However, the workforce has not yet fully recovered, and the participation rate remains close to 56% (in contrast to a historical average of 61.5%). We believe the ratio between the working population and occupied population should accelerate until the first quarter of this year. In other words, there will be more people returning to the labor market than people finding jobs for a reasonable time throughout 2021. This hypothesis, combined with inertia and the natural lag between the labour market and economic activity, translates into a peak of unemployment rate of 15.8% in the second quarter of 2021.



As for GDP, we maintain our forecast of 3.4% growth in 2021. The hypothesis behind this number are: i) stronger households and businesses confidence in the first half of the year; ii) An effective vaccination campaign; and iii) some progress in the reform agenda in the Congress.

For 2022, growth is expected to accommodate at 2.00%, closer to its potential. For this scenario to materialize, however, it is important to make progress on the reforms in 2021, shielding the economy from the volatility inherent to the electoral process and the fiscal uncertainty of a country with debt / GDP above 90%.



Inflation remains under pressure, but should recede over time

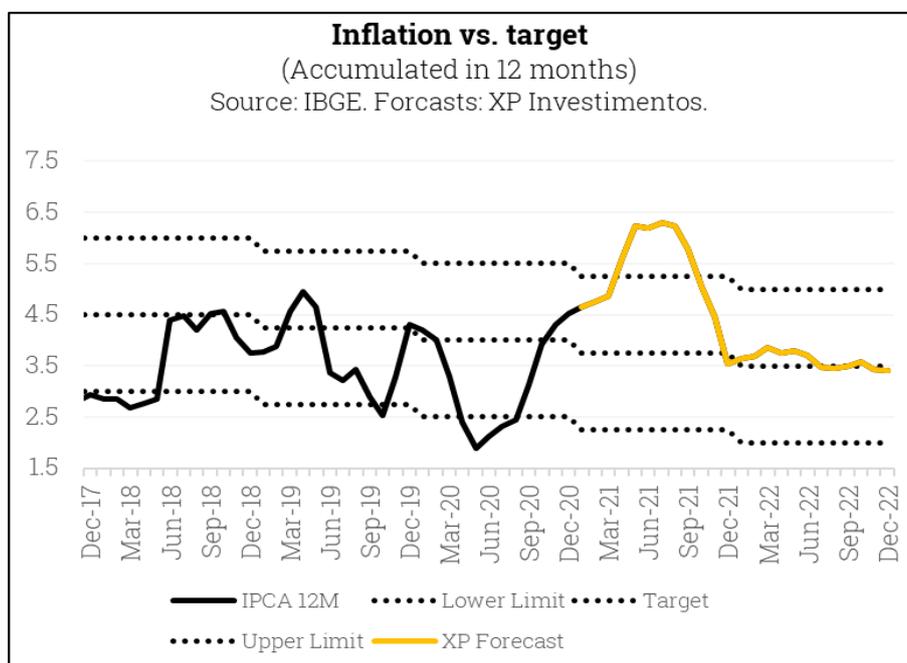
IPCA inflation ended 2020 at 4.52%. The result is surprising, considering that until the third quarter of last year, market expectations were around 2.00%. The spike in the last months of the year was lead by a number of factors, most of which being the increase in commodity prices, the mismatch between domestic supply and demand in the durable goods sector and the recovery of margins in the service sector.

We expect these shocks (albeit temporary in nature) to remain in place for some time, keeping current inflation under pressure for a while. Food inflation, which showed signs of deceleration in mid-November, has re-accelerated. The FX depreciated again, following the increase in fiscal uncertainties and the rise in long-term interest rates in the US. Meanwhile, fuel prices currently stand at about 15% below international parity – according to the National Petroleum Agency.

Nonetheless, we still see inflation easing throughout 2021. The end of the stimulus programs should help slowing domestic demand. The job market also remains fragile despite the recent improvement, marked by high idle capacity. Finally, we believe that the FX should resume its appreciation trend (see external sector section below).

Throughout the year, YoY IPCA should rise until it exceeds 6%, then decrease as base effect fades. We forecast IPCA at 3.5% in 2021. However, with the recent trend in the exchange rate and commodity prices, we understand the inflationary hump may last longer than expected, bringing an upward bias to our projection for this year.

In a scenario where the spending ceiling is maintained and gradual increases in interest rates are implemented from the third quarter of 2021 on, we expect inflation to converge to the target next year. IPCA should end 2022 at 3.4% (vs. 3.5% of target).



Fiscal: tough 2021, easier 2022

The general government primary deficit reached 8.93% of GDP in November (12-m accumulated). Despite the record deficit, the results were better than expected, mostly a reflection of improved tax collection on the back of the resumption of economic output, and the return of taxes deferred in the first half of the year - close to 60% of total so far.

We altered our projection of the primary deficit expected for 2020 to 10.7% of GDP (from 11.3% of GDP), while gross debt should reach 90.2% of GDP by year end.

Nevertheless, challenges remain greater than ever in 2021, and the fiscal debate should remain central in the coming year. First, Covid-related expenses not subject to the spending ceiling amounts BRL 36 billion (most of it for vaccination programs).

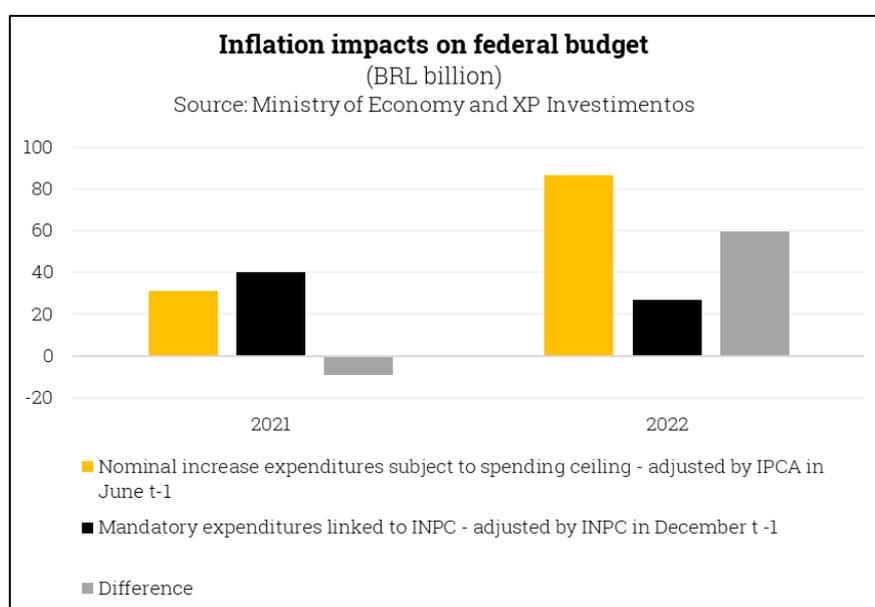
As for spending subject to the ceiling, rising inflation in recent months continues to add pressure on mandatory spending - BRL 23 bi according to our calculation, taking discretionary expenditures to a record-low of BRL 69 billion.

A possible relief may come from the effects of the pension reform, as observed in 2020, that could partially offset the loss in approximately BRL 8 billion.

We expect the general government to register a primary deficit of 3.1% of GDP this year, raising the gross debt / GDP ratio to 91%. It is worth noting that the return of the debt due by the BNDES to the National Treasury, whose parcel referring to 2020 was postponed due to the pandemic, adds a positive bias to the debt trajectory.

In turn, 2022 may bring some relief to the scenario. The same dynamics that tightens this year's budget should benefit the government next year. By correcting expenses by the spending cap rule according to the IPCA from June this year (when we project the index close to 6%), the expected drop on inflation in December should open room in the 2022 budget – one that might reach approximately BRL 60 billion, as per preliminary calculations.

We estimate the primary deficit at 2.3% of GDP in 2022, with debt-to-gdp ratio achieving 92.3% - more that 1 percentage point above 2021 figure.

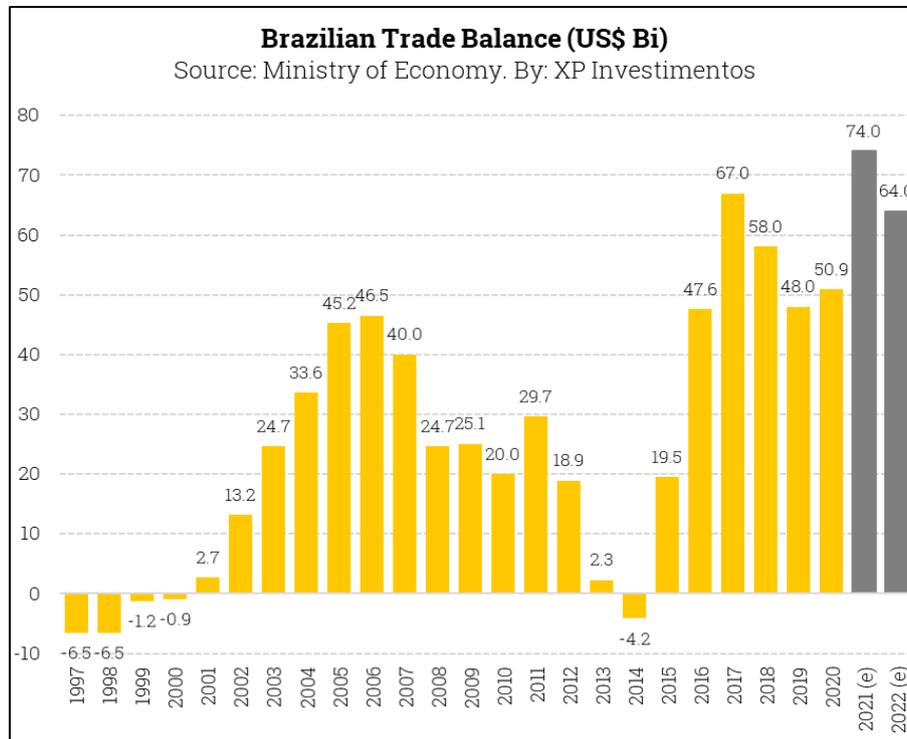


Even more positive trade balance, the exchange rate should resume appreciating

The Brazilian trade balance ended 2020 with a positive balance of US\$ 50.9 billion, slightly above the US\$ 48.0 billion in 2019, as a result of a drop in both exports and imports. We see a resumption in Brazil's trade flow in 2021, given a scenario of economic recovery, coupled with effective vaccination programs, both domestically and in Brazil's main trading partners.

On the import side, manufacturing products (about 90% of our imports) should recover as soon as domestic demand improves. As a result, we project an 18% increase in Brazilian imports for 2021, reaching US\$ 187 billion.

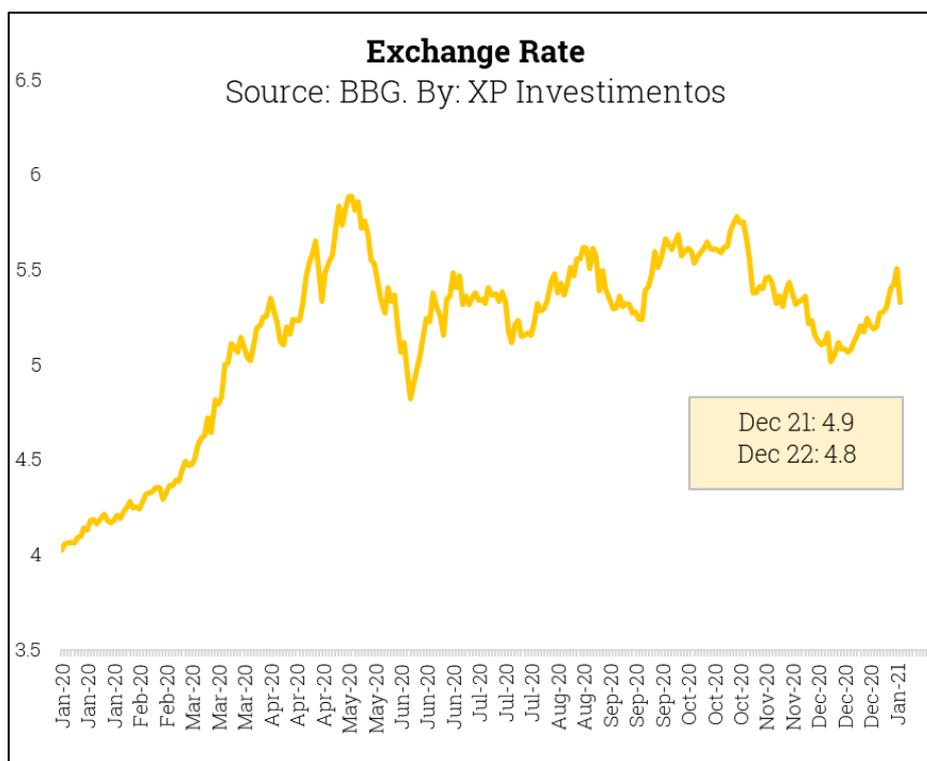
Exports, in turn, will mainly benefit from high commodity prices and the recovery of our trading partners. Therefore, we see an increase of 23% in the export value this year, to US\$ 259 billion, and total trade balance at US\$ 72 billion, above the market consensus. For 2022, the additional recovery in domestic demand, associated with some correction in commodities prices expected by the market, should bring the trade surplus to US\$ 61 billion -- the result of US\$ 267 billion in exports and US\$ 206 billion in imports.



On FX, the Brazilian Real has not started the year on a good note. Contrary to the last months of 2020, the BRL has lagged (again) its peers and delivered negative spot returns so far.

Although our short-term models, which include only external variables, do not flag significant misalignments in the recent depreciation, our structural model continues to point to an appreciation of the Brazilian currency throughout the year, with a target price of 4.9 / USD at the end of 2021. For 2022, the model indicates a continued appreciation of the Real up to 4.8 / USD at the end of the year. Our estimates consider a weaker dollar, rising domestic and foreign interest rates, commodity prices and terms of trade in line with their futures, and the local CDS rising to 250 around the 2022 presidential election.

Should the current fiscal regime be maintained, we continue to see a constructive path for the Brazilian currency in the medium-term.



Monetary Policy: when will the hiking cycle begin?

The Central Bank has kept the interest rate at 2.0% since August last year, a level that it recognizes as being extraordinarily accommodative. In addition, it adopted the forward guidance tool, indicating that rates should remain low ahead, in an attempt to also curb the future interest curve.

The monetary super-stimulus made sense when it was implemented, as inflation expectations were below target, and falling. The picture now has changed. Inflation expectations are close or at the target for the coming years. Therefore, the discussion becomes when - and at what pace - interest rates will start to normalize.

We understand that there will be no rush to raise the Selic rate. The inflation shock still seems temporary, unemployment should remain high and monetary policy will play a greater role in sustaining the economic recovery with the withdrawal of fiscal programs.

Thus, we continue to forecast a gradual increase in the Selic rate during the second half of 2021, up to 3% at the end of the year. The cycle tends to extend to 2022, up to 4.00% by the middle of the year.

However, if the risks on the inflation front (mentioned in the inflation section above) materialize, the Copom may opt to raise interest rates earlier - possibly in May, when the information set on these risks and on the effect of the end of emergency aid will be more complete.

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