



MACRO YEAR AHEAD: LIFE AFTER COVID

December, 8th 2020

 **XP** investimentos



MACRO INTERNATIONAL

USA

The US electoral authorities had yet to declare the winner of the 2020 presidential election as of publishing time, yet all indications remain that Joe Biden will be inaugurated on January 20, 2021 as the new president of the United States. President Trump has already instructed his team to move forward with the transition logistics while his legal challenge to the election continues. The electoral college will meet on December 14 to name a president, and we expect the electoral college to name Joe Biden as the new president that day. We think that President Trump's exit strategy out of this conundrum will be to announce that he will be running again in 2024. Trump will be leaving the White House a one-term president, but also as the sitting president that has received the most votes in history up until now (*almost 74 million*).

We expect the Republican Party to win the two Senate run-off races in Georgia this coming January 5, 2021. We think that the Republican Party keeping the majority in the Senate (52-48) is a positive development for markets. The Democratic Party controlling the Senate would indeed have meant the possible approval of a massive fiscal stimulus package (*north of USD 2 trillion*), with a large infrastructure component. Still, a NO blue wave also means that (1) *meaningful individual or corporate tax hikes are now unlikely*, (2) *no Supreme Court-packing*, (3) *no ending of the filibuster rule*, (4) *no moratorium on fracking*, (5) *no single-payer health insurance system*, (6) *no meaningful detrimental actions against technology giants*, and (7) *no material changes in environmental regulation standards*.

We still think that the markets may see an approval of some sort of stimulus package in the next few weeks, but, if approved, the package will be materially smaller compared to the expectations that were present before the presidential election. The package will be smaller because Speaker Pelosi will now be forced to negotiate with Treasury Secretary Mnuchin, but it will be larger than the Senate wants, as Majority Leader McConnell will need to compromise ahead of the January 5th Georgia runoff. In our view, the implications of a "no action" course when (1) *the eviction and student loan moratoriums are set to expire on December 31*, and (2) *when the extended unemployment benefits for 12 million unemployed people in the US are set to expire by year-end*, could prove very costly for both parties.

Our in-house models are delivering that the US economy is set to contract 3.5% y/y in 2020, but also that it could feasibly expand north of 5% y/y 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. The Trump administration expects all the medical personnel and nursing home inhabitants in the country to be vaccinated by December 31, 2020, and for the whole (*willing*) US population to be vaccinated by April of next year.

Vaccination and Europe

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 –i.e. *similar to how it was in 2019*. We think that robust economic growth and lingering ample liquidity (i.e. “dry powder”) will push the S&P 500 up to 4,000 by year-end 2021, up from 3,700 by the end of this year (*our current forecast*). We see 2021 SPX adjusted earnings reaching \$161, delivering an increase of 15% y/y. We believe that our forecast remains on the conservative side. For YE 2022 we see adjusted earnings reaching a record of \$173.

On the monetary policy front, we expect 2021 to be a “Goldilocks” year for the Fed. We expect the FOMC to find solace in the high likelihood that a strong recovery will be underway, as the “epicenter” sectors mean-revert to something closer to normality thanks to the availability of a vaccine. This will allow the FOMC to take a “hands-off” approach in terms of being forced to deliver additional stimulus. On the other hand, the massive size of the current output gap will keep reflation pressures from erupting. It is true that key inflation measures will likely increase in Q221, as the y/y comparison base will be very low, but we expect that performance to prove temporary. Still, the markets will probably start to price-in that somewhat higher rates will be forthcoming in the future. **Our expectation is that the US 10-year bond will end 2021 yielding 1.1%, up from 0.7-0.8% by year-end 2020.**

Moving to Europe, we also expect vaccination efforts there to be successful, allowing for epicenter sectors to make up for some of the lost ground. The speed of the recovery in Europe 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.

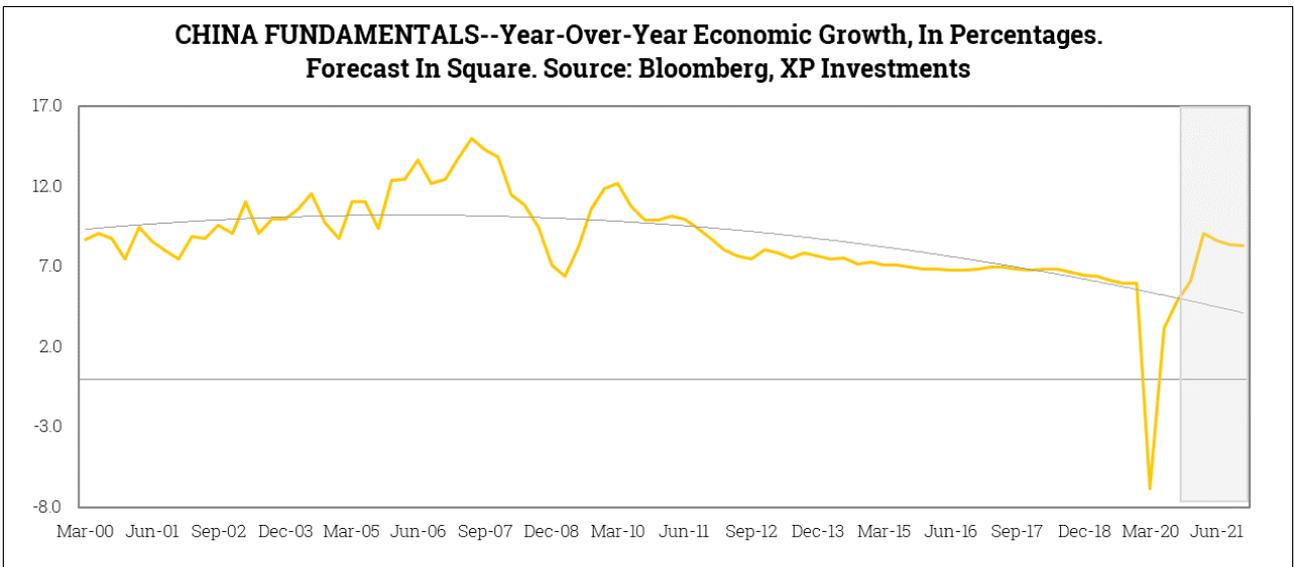
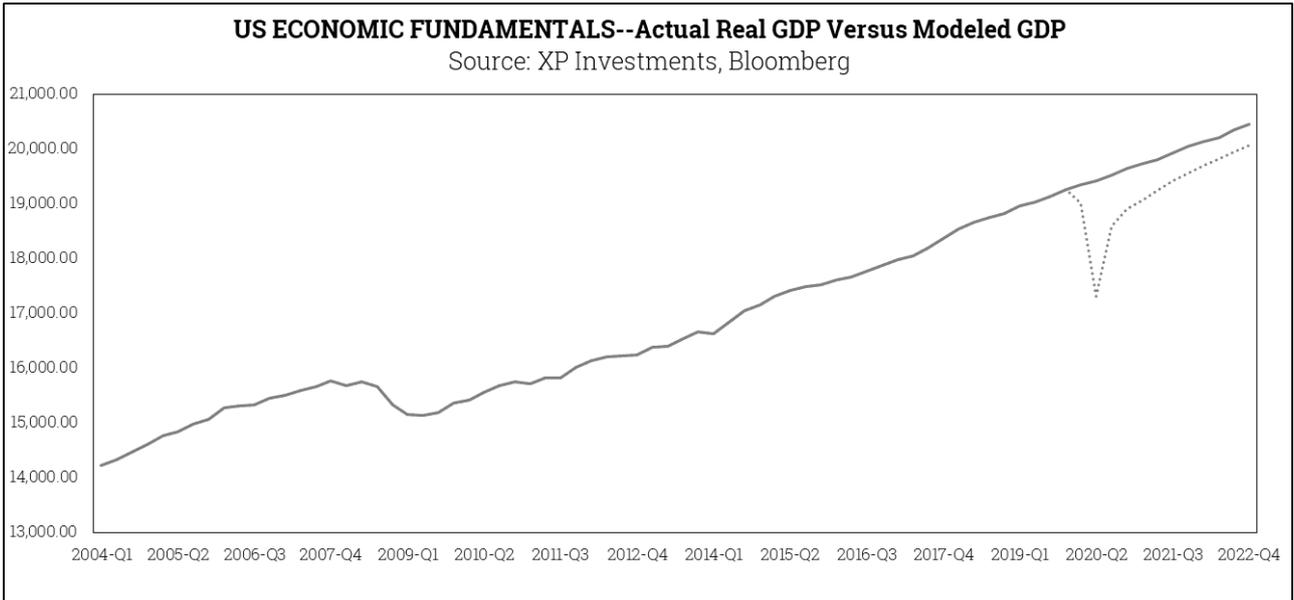
We do think that the ECB will feel forced to deliver increased stimulus measures either this December or in early 2021 --we would look for a material increase of the PEPP envelope to around €2 trillion (from its current size of €1.35 trillion), an extension of the minimum fixed date for net asset purchases until mid-2022 (currently until mid-2021, at least), and a cost reduction of the TLTRO III. Europe being forced to deliver an increased stimulus is unlikely to manifest itself in a depreciation vis-à-vis the USD in 2021. A lingering very high current account surplus, tied with the USD being clearly overvalued in real terms, will most likely force the € to trade north of 1.2 during 2021. We expect the € to end 2021 at 1.25 to the USD.

China

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% y/y in 2020 and an impressive 8.5% y/y 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 showing rates of growth of more than 10% y/y. Consumption will also remain supported on the back of a low comparison base, still highly expansionary monetary policy, and lingering pent-up demand. We also believe that the level of animosity that currently exists between the US and China will fall somewhat under a Biden administration. That said, it would be illogical to expect a review of the current tariff structure to take place at this stage, as those tariffs are generating material levels of fiscal revenues for the US treasury at this time, and because the level of resentment of US citizens with China remains very high. On the FX front, we see the USDCNY trading at 6.30 by year-end 2021.

Regarding the outlook for Latam assets, we continue to think that a scenario of the Senate remaining in Republican hands remains the best possible one for the EM region, as US tax policy will most likely remain stable, monetary policy should not change, and anti-outsourcing sentiment should remain relatively constrained. The now almost full certainty that a very effective vaccine will be available for the Latam region in the short-term (*AstraZeneca-Oxford vaccine*) is also a positive omen for the future performance of the region. In addition, we now 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, a clear positive development for the Argentine, Peruvian and Chilean economies. We expect Mexico’s economy to rebound 5.5% y/y in 2021, after having fallen an estimated 9% y/y during 2020. In the case of Argentina, we see GDP falling 10% y/y in 2020 but rebounding 6.5% y/y in 2021. We see an almost unitary possibility of Argentina and the IMF being able to reach an agreement to sign an EFF agreement in Q121 which will likely be growth enhancing. We see Colombia falling 7.5% y/y in 2020 and rebounding 5.5% y/y in 2021.

We think that Latam FX remains dirt cheap at current levels and we are particularly bullish on the USDMXN, which will remain as one of the highest yielding currencies and with more room to appreciate given improving trade balance dynamics with the US. We see the USDMXN trading at 18.75 by YE 2021. We think that the USDCOP will be one of the main regional beneficiaries of the likely positive future behavior of oil prices (*we see the USDCOP trading at 3,375 by YE 2021*). We see the USDCLP ending 2020 trading at 730 despite lingering political uncertainty.





MACRO BRAZIL

Brazilian Economy in 2021: many doubts and one certainty

The Coronavirus pandemic and its peculiar effects bring uncertainties for the Brazilian economy in 2021. Will the recovery continue? On the one hand, the end of emergency aid and second wave of Covid-19; on the other, low interest rates, labor market recovery, and the vaccines entering the final stretch. Will current inflationary pressure last? Higher costs continue to intensify, but still elevated unemployment and the supply side reaction may eventually contribute to price stabilization. Will the exchange rate appreciate, following other emerging currencies? Will the Central Bank begin the process of normalizing real interest rates? Shall the structural Reform agenda finally move forward?

If anything is certain, however, is that fiscal management will be incredibly challenging, regardless of discussions over expanding new social transfer programs or boosting infrastructure investment. This, allied to approaching presidential elections (in October 2021 we will be one year from the election), increases the complexity of the scenario, especially in the second half of 2021.

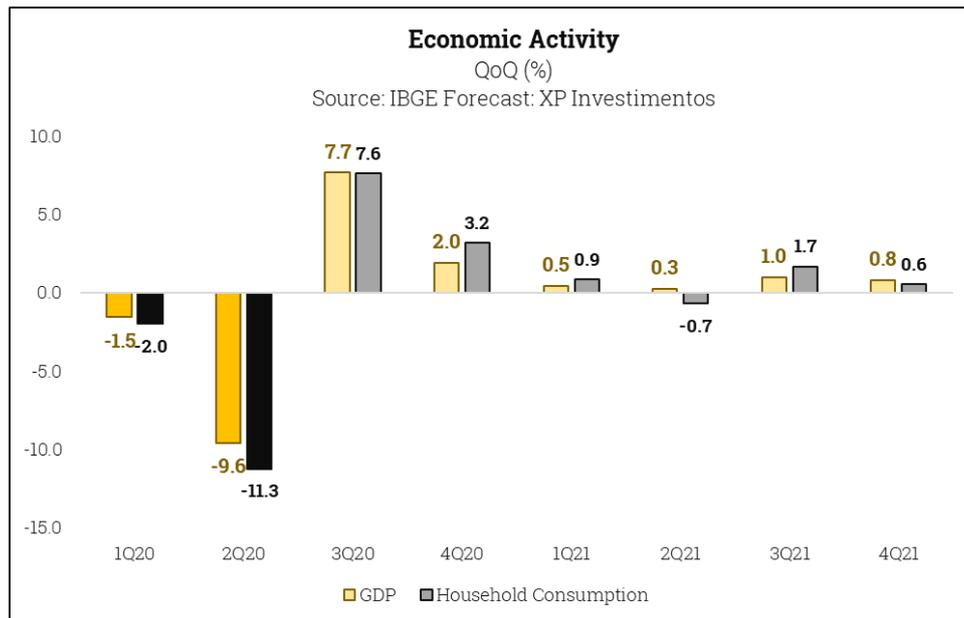
Beginning of the year: focus on growth

With the National Congress in recess between December and January, the first major theme of the year will be the impacts of the end of government programs on economic activity, following the boosted “V-shaped” recovery of consumption in the second half of 2020. Moreover, cases of Covid-19 have accelerated in recent weeks and may weigh on economic output in the fourth quarter of 2020. Even if regional governments opt for no new restrictive measures, increasing risk aversion by households and firms should already impact activity.

The extent of this impact depends on vaccination campaigns, which, in our base scenario, begins in the first quarter of 2021.

As for the engines of growth, on the one hand, the end of income transfer and employment support programs should reduce households' perception of income. On the other hand, we believe that the ongoing recovery of the labor market and the circumstantial savings made by the middle and upper classes during the pandemic should allow consumption to grow above income for a while ([click here to check more details](#)). The highly expansionary monetary policy should also help support domestic demand.

As a result, we expect aggregate consumption, as well as GDP, to continue to expand throughout 2021, albeit at a slower pace than in the second half of 2020.



Can Emergency Aid be extended? Can it help growth in 2021?

The acceleration of Covid-19 cases in recent weeks has brought back the debate about the possible extension of emergency aid in 2021. This should not be seen as a feasible move. Firstly, because the country's fiscal space, which was already limited before the pandemic, became virtually non-existent. Any additional expense must be well thought out and clearly proven necessary. In addition, its implementation would not be easy, on the contrary, it would demand careful coordination with the Legislative branch and the Federal Court of Accounts (TCU).

Anyway, if the second wave of Covid-19 affects the country to the point of justifying an extension of the aid, we would be already in a worse scenario for the economic activity.

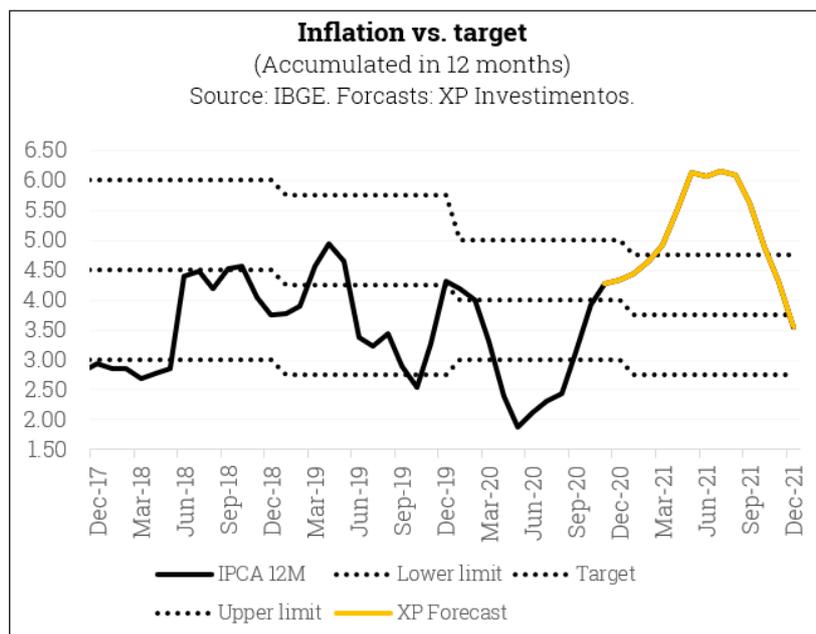
A hump-shaped Inflation dynamic

Inflation has risen in recent months. The intense fiscal and monetary stimuli, the sharp rise in commodity prices (not followed by BRL appreciation), the rebuilding of margins in services, and the mismatch between supply and demand for industrial goods add pressure on consumer prices. This movement has yet to show signs of accommodation.

The FGV's producer price index (PPI) reached 33% YoY in November. Part of that pressure has yet to be passed through consumption. Several sectors of durable goods have been reporting that the imbalance between supply and demand should adjust only during 2021, what keeps prices pressured in the coming months. Additionally, the service sector should continue to restore margin as the vaccine allows the economy to normalize.

In this context, IPCA inflation should reach 5.5% YoY throughout the year, before declining to 3.8% in December. The economy's spare capacity, especially in the labor market, and a stronger BRL (we forecast 4.9 reais to the US dollar by 2021 year-end) should contribute to the fall of the IPCA in the second half of 2021.

But for this hump-shaped trajectory to be confirmed, it is also necessary that long-term inflation expectations remain anchored. For now, despite the dispersion of the projections for 2021, the projections for 2022 collected by the BC's Focus survey have remained stable, which is good news. This will be a key variable in the coming months.

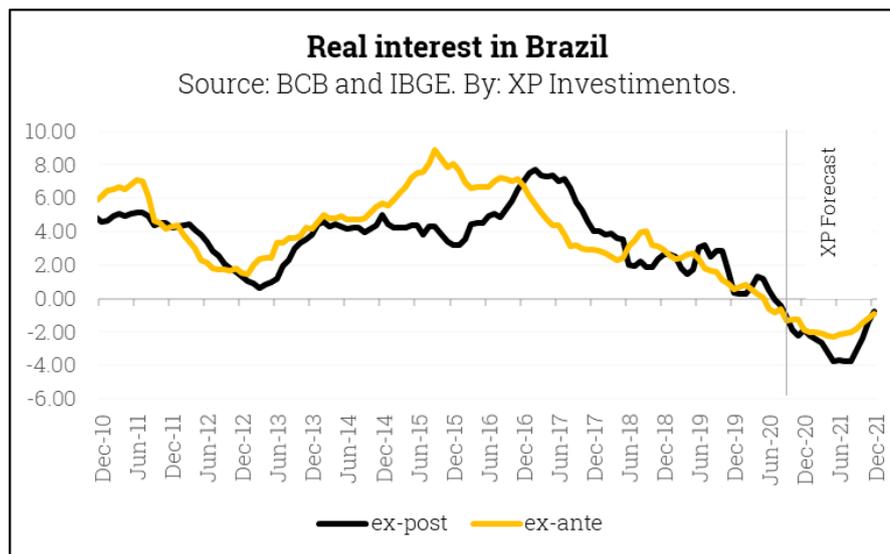


Negative real interest for so long: never before in the history of this country ...

The Central Bank is not concerned about higher short term inflation. The Monetary Authority points out that the shock is temporary, citing output gap and anchored inflation expectations as factors that keep the core inflation consistent to the target path. Thus, we, and the majority of the market, do not expect interest rates to rise at least until the second half of next year.

The fiscal scenario is a risk. If there is a change to the current fiscal framework, especially in the spending cap rule, which compromises the stability of the public debt, the BC may raise interest rates earlier than expected. But this is not our base scenario for 2021. Without a fiscal break, the base scenario projects a long period of negative real interest.

The economic fundamentals and the prolonged effects of the pandemic back this scenario. Still, for a country with a history of high interest rates, and that has shown little structural evolution in recent years, it seems a bold scenario.



Note: Ex-post: Taxa Selic - IPCA 12M. Ex-ante, 1-year pre-fixed interest rates (DI futures swap) – 12-month inflation expectation (Focus Survey BCB).

What about reforms?

Another uncertainty for 2021 is the approval of structural reforms. The Emergency Constitutional Amendment (PEC Emergencial) - critical to improving fiscal governance framework - and the Tax and Administrative reforms are in the pipeline. There are still relevant micro advances, such as the BCB's Independence, the Gas regulatory framework, and the new legal framework for Cabotage (BR do Mar).

If our scenario of maintaining the spending ceiling and keeping growth at the beginning of next year proves accurate, there will be a window of opportunity for the Government to approve those measures in Congress.

The priority must be the emergency PEC, as fiscal pressures are likely to increase significantly as of the second half of the year (see next section). Additionally, we believe that at least one of the sectoral measures will be approved, which is positive. It is worth noting, from a positive point of view, the recent approval of the New Bankruptcy Law. As for Tax and Administrative, however, some progress is possible, but it will be a surprise if these are approved.

A certainty: in any scenario, fiscal management will be painful

The pandemic has renewed the discussion of income distribution in Brazil. Pressure has grown to increase the budget for cash-transfer programs such as Bolsa Família. The government has clearly signaled that this movement can only happen if it fits within the spending ceiling, that is, replacing some other expenditure.

Even in the absence of a new (or larger) social program, meeting the spending cap in 2021 will be challenging. The 2021 budget proposal (PLOA) sent to Congress in August foresees spending exactly in line with the spending ceiling. The PLOA foresees mandatory expenses of R\$ 1.4 trillion (over 90% of the total), and discretionary expenses of R\$ 112 billion (or just over 7% of the total). However, the acceleration of inflation in the second half of this year implies an increase in mandatory expenses above the forecast for next year, due to the constitutional indexation of the minimum wage and Social Security. In the same vein, the extension of payroll tax exceptions to some sectors until the end of 2021 also adds a mandatory expense not included in the PLOA. Together, these effects represent approximately an additional R\$ 25.6 billion, which should be cut from discretionary expenses. That is more than a 25% cut!.

Budget 2021		
	PLOA 2021	Following payroll subsidies and INPC adjustment
Total	1,516,799.90	1,516,799.90
Mandatory	1,404,402.70	1,430,046.80
Discretionary	112,397.20	86,753.10
Discretionary after capitalization and amendments	92,052.70	66,408.60

(BRL million). Source: PLOA and STN. Prepared by: XP Investimentos

This means that, likely in the second half of 2021, the Executive will be forced to cut politically sensitive expenditures. We may see a shutdown in relevant public services, with strong potential for political noise.

By then, we will be approaching the end of the presidential mandate (as of October, we will be less than 1 year from the presidential election). Thus, the pressure on the fiscal framework will be enormous. This particular juncture will meet, according to our projections, the peak of the inflation and unemployment rate trajectories.

It's worth noting that this dynamics stands valid regardless of the improvement seen in debt/GDP projections (1). It reflects a change in methodology used by IBGE in calculating the GDP, and should not be regarded as a fiscal improvement – even if it pushes further the 100% ratio barrier.

In this environment, the risk of populist shifts in 2022 increases. This, however, we leave for next year's Year Ahead edition.

XP Forecasts				
	2018	2019	2020 (E)	2021 (E)
GDP growth (%)	1.3	1.1	-4.6	3.4
IPCA (CPI, 12m, %)	3.75	4.31	4.3	3.5
SELIC rate (% p.y., end of period)	6.5	4.5	2	3
FX (USDBRL, end of period)	3.9	4.0	5.2	4.9
Primary fiscal deficit (% GDP)	1.6	0.9	11.3	3.1
Gross debt (% GDP)	76.5	75.8	90.9	91.6

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

(1) Following IBGE's methodological change, the projection of nominal GDP rose to R\$ 7.34 trillion for 2020 (from R\$ 7.16 trillion) and to R\$ 7.92 trillion for 2021 (from R\$ 7.26 trillion). Therefore, we revised our DBGG / GDP projections from 93.1% to 90.9% for 2020 and from 94.2% to 91.6% for 2021.



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