Sovereign Macro- Brazil Copom preview, remember Mike Tyson

October 25, 2021

Bottom line: 2x150 and then see what happens; terminal rate could be anything, penciling in 12% terminal rate. Despite the message from Bacen's leadership that they believed that a pace of normalization of 100bp per meeting was adequate and sufficient to meet its inflation target of 3.5% in 2022, last week's developments force the Copom to reconsider. As Mike Tyson used to say, everybody has a plan until they get punched in the face. The risk premia in Brazilian assets due to the fiscal mess and the impending election cycle have risen substantially. Bacen is the only game in town, and it is already operating under a lot of stress due to several inflationary shocks, significant FX volatility, and now an emerging threat that inflation expectations may have started to de-anchor for 2023 and 2024, at least according to today's Focus Survey. Because the backdrop has worsened so much in relation to Bacen's baseline scenario, the Copom must act swiftly with a 150 bp hike and a strong guidance that it will act *by at least the same amount in December*. My call before this "hebdomadis horribilis" was for a terminal rate of 10.25% for the Selic rate at 100bp a clip. With the risks ahead it is almost impossible to provide an educated opinion of where the Selic will end because nobody has any idea of how restrictive policy should be under the current scenario, in other words, the terminal Selic could be almost anything. As recently as 2016, the nominal Selic hit 14.5% and in 2005 it was 19.5% and real rates of 7% and 13% respectively. With not a lot of conviction, I am penciling in a Selic of 12% by May 2022 including 2 hikes of 150, 2 of 100bp and a final one of 75bp; the risks are clearly to the upside. At 12% Bacen would set a future real Selic rate of about 7% in 2022, like what we saw under Dilma. I feel that I am still at the mercy of Mike Tyson.

- The macro tripod of fiscal austerity, a floating exchange rate, and an inflation targeting regime has been severely damaged. With the approval of the social security reform and the adoption of the spending cap, all mostly under president Temer, it seemed that the fiscal anchor would finally consolidate. As a result of the pandemic, emergency measures were necessary, and the spending cap rules were temporarily suspended to attend the low-income population. The discussion of extending them further when infections and vaccination became more successful was a serious warning sign. The intention to default on precatorios was even more alarming. So last week's developments were not a complete surprise, but the speed of the deterioration was certainly unexpected. The spirit of the spending cap, which called for the reallocation of spending in certain areas to favor others was abandoned. The "solution" was to reformulate the cap to give more room for discretionary spending, default on the precatorios and boost election related spending. One must be pretty naïve to think that the extra 200 BRL of Auxilio Emergencial through the end of 2022 is temporary. The government is now considering spicing up spending even more with Vale Gas and Bolsa Caminhoneiro, which are subsidies for propane consumption and bus drivers. With inflation running high, it will be difficult to stand up to pressure from government workers to increase their wages which have been frozen for a couple of years. Moreover, who knows how creative congress will be when it considers the vote of the Auxilio Emergencial, it could be 600BRL for all we know.

- Going back to the macro tripod, it is now up to Bacen to keep things more or less together. In their last few communications, the Copom noted that the balance of risks was asymmetric and to the upside on account of fiscal factors. The FX has moved more than 6% since the last Copom which by itself should add about 20-25bp in inflation. Expectations for this year and through 2024 have increased and more energy price adjustments are in store. Importantly, today's Focus survey of expectations for 2023 and 2024 moved up by 2bp to 3.27 and 3.02% respectively for the first time. It was not the magnitude what mattered as much as the direction in which they are moving. For a central bank operating in an inflation targeting regime this is pretty serious stuff. Bacen will be pressed to cut this emerging trend at the bud.

Jaime Valdivia

Sovereign Macro

Founder and Chief economist

jaime.valdivia@sovereignmacro.com