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Fading inflation shocks is the most likely scenario

- **The domestic scenario shifted towards higher short-term inflationary pressure.** Therefore, our main revision relates to the inflation forecast for this year, up from 6.4% to 7.1%. Amidst these pressures, we believe the Central Bank of Brazil will choose to raise the Selic rate to 7.00% by the end of the year, compared to the 6.50% rate previously estimated.

- **We have maintained our GDP growth forecasts at 5.2% for this year and 2.2% for 2022.** Consumption of goods remains strong even after the increase in demand for services, confirming the hypothesis of savings accumulated during the pandemic. Early on in the third quarter, we noticed some accommodation in trade and industry data in our proprietary surveys, at rates compatible with the forecast growth.

- **Public finances still show positive results, amidst the GDP growth and inflation acceleration, but spending-related risks must still be closely monitored.** With the spending cap preserved and extraordinary expenses with the pandemic nearing BRL 130 billion per year, we should reach a primary deficit of 1.5% of the GDP in 2021 and 1.0% in 2022. Gross debt, in turn, should reach 81.8% of the GDP this year and 82.7% in 2022.

- **Our exchange rate forecast remains between BRL/USD 4.7 and BRL/USD 5.3 for 2021 and 2022.** We see signs conducive to the real's appreciation, in response to the fundamentals. In fact, our fair value models continue to indicate a rate around BRL/USD 4.3. However, the balance of risks has proved to be important for the currency's monthly behavior.

- **The monetary policy's reaction to shocks should take into account their nature, the unprecedented nature of the pandemic and uncertainties they carry over into forecasts, in addition to the risk of spreading, which is apparently low.** A more powerful monetary policy, the more incisive discourse of the Central Bank, and the dissipation of current shocks should help prevent the normalization from converging into a conventional monetary tightening process.

More balanced global scenario risks

- **After a few months leaning towards the positive range, the balance of risks of the foreign market is closer to neutrality.** The progress of vaccination rollout, reopening of the economy, and fiscal and monetary stimuli resulted in many positive surprises coming from economic data, feeding the risk appetite among investors in the last few months. However, this series of favorable news now seems to be better priced in asset markets. At the same time, there are still concerns that inflation would force central banks to normalize the monetary policy much faster than anticipated. This ultimately led to more balanced risks in the global scenario.

- **In this context, the global upsurge in the number of cases of the Delta variant has been the main concern in the scenario, including in Europe.** The evidence thus far suggests that the greater transmissibility of the new variant leads to an increase in the number of cases, but vaccination apparently grants protection against hospitalizations and severe forms of the disease, keeping mortality rates low. Therefore, once low hospitalization rates in vaccinated countries are confirmed, even amidst a rise in the number of cases, concerns with the Delta variant tend to tone down and ultimately prompt a greater risk appetite in the markets.

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Fading inflation shocks is the most likely scenario

The domestic scenario shifted towards higher short-term inflationary pressure. Therefore, our main revision relates to the inflation forecast for this year, up from 6.4% to 7.1%. Amidst these pressures, we believe the Central Bank of Brazil will choose to raise the Selic rate to 7.00% by the end of the year, compared to the 6.50% rate previously estimated. Regarding the economic activity, we assess that expectations remain favorable, but there seems to be less room for positive surprises from now on, despite the expected post-pandemic normalization.

We have maintained our GDP growth forecasts at 5.2% for this year and 2.2% for 2022. Despite the negative surprise with the IBC-Br from May, the data as a whole continue to suggest a recovery of economic activity, which led us to maintain our assessment regarding growth in the year. Demand is still a highlight in this process, compatible with the progress of vaccination rollout and the reopening of the economy. Consumption of goods remains strong even after the increase in demand for services, confirming the hypothesis of savings accumulated during the pandemic. Early on in the third quarter, we noticed some accommodation in trade and industry data in our proprietary surveys, at rates compatible with the forecast growth.

Recent credit indicators support a constructive outlook. The household indebtedness indicator, which has been rising, seems to "suffer" from the challenges imposed to the assessment of employment and income data during the pandemic, since such increase has not been followed by an increase in default rates. The increase in household assets, not considered in indebtedness indicators, also contributed to lower indebtedness risks. Regarding corporations, deleveraging persists. It is important to underline that the housing sector's good performance in the last few months, even at the height of the pandemic, has started to reflect into greater credit expansion to companies in the sector, which should also help create new jobs. We estimate a 12% growth in loans this year.

In the job market, the informal sector – lagging with recovery – should benefit from the upsurge in the service sector. Formal employment, on the other hand, is reasonably above pre-pandemic levels across all regions of the country. Part of such improvement in formal employment is linked to dividends of the 2017 labor reform, since many new hires have been concentrated in small companies. This could broaden the economy's formalization in the months ahead. For 2021, we expect the creation of approximately 2.5 million jobs, with the unemployment rate dropping to 12.8% by the end of the year (13.8% in the 2021 average).

Thus, with indebtedness under control and good credit prospects, household consumption should continue to grow over the next few months. Confidence also continued to recover in the beginning of the third quarter, with greater gains in expectations than in perceptions of the current scenario. Exports, in turn, are still favored by the global groth, including in sectors not related to commodities, but the additional global impulse also seems to be lower. On the supply side, the industrial stock replenishment cycle is still driving expansion. It is important to note that restrictions related to supplies remain across several sectors, albeit at a lower scale compared to the beginning of the year. Moreover, adverse climate shocks have already led to bearish impacts on the production of some agricultural goods that make up the GDP. In this sense, we believe our growth forecasts are well calibrated and currently unbiased. The evolution of the pandemic and water crisis are still important risk factors.

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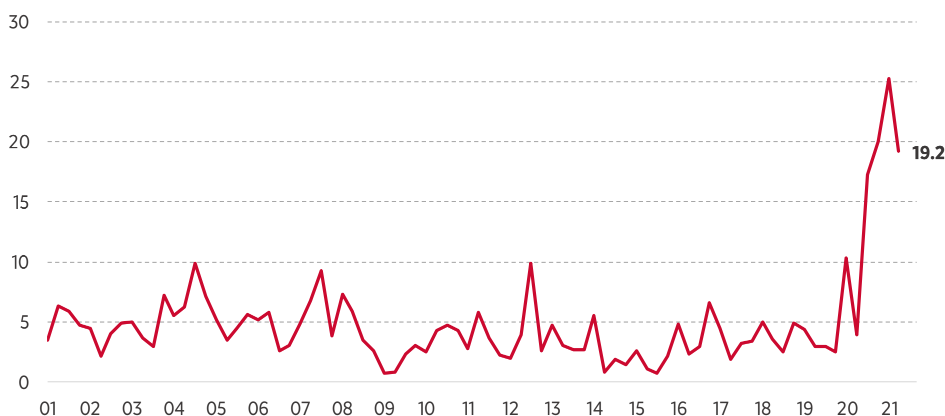
Chart 1: Companies indicating lack of supplies as a limiting production factor
% of responses in the industrial sector



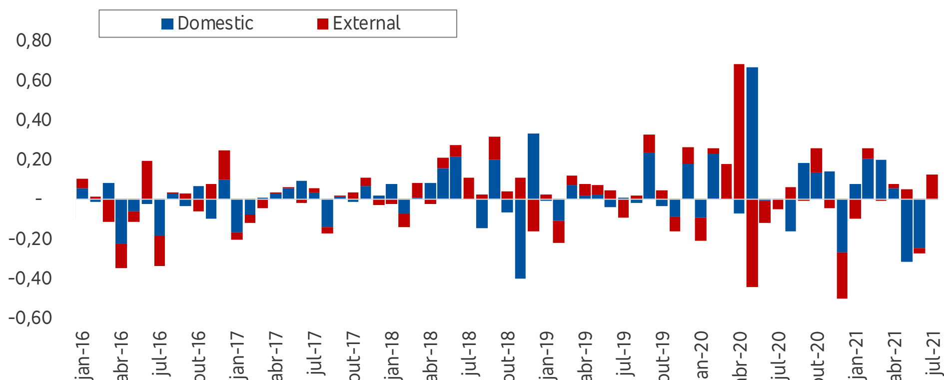
Source: FGV, Bradesco

Public finances still show positive results, amidst the GDP growth and inflation acceleration, but spending-related risks must still be closely monitored. Primary federal revenues should reach BRL 1.8 trillion this year, a real increase of 15.0% compared to 2020 and 3.1% compared to 2019 (excluding additional funds from the transfer of rights). With the spending cap preserved and extraordinary expenses with the pandemic nearing BRL 130 billion per year, these positive results on the revenue side lead to a primary deficit of 1.5% of the GDP in 2021 and 1.0% in 2022. Gross debt, in turn, should reach 81.8% of the GDP this year and 82.7% in 2022.

The debt's long-term dynamics still depend upon the fulfillment of fiscal rules. Maintaining the current spending cap and no changes to the tax burden, a primary surplus is expected in 2024 – 2 years earlier than in our previous estimates. In our premises, the expansion of the *Bolsa Família* program and eventual new mandatory expenses will remain within the limit of next year's spending cap. Despite the improvement in indicators, the maintenance of a fiscal framework consistent with the medium-term consolidation of the public debt is still the main hypothesis for future interest and exchange rate scenarios. Considering the country's indebtedness, the recent revenue "surplus" is very welcome to anticipate fiscal consolidation, which already has led to improvements in risk premiums. The benefits of debt relief far outweigh any other possible allocation for revenues at this moment.

The exchange rate showed great volatility, but small depreciation in the last month, reacting primarily to a worsened global scenario. Unchanged external fundamentals remain positive and still indicate an appreciation of the currency in the coming months. In fact, we expect a trade balance surplus of $ 76 billion, as well as a surplus in current account balance at 0.7% of the GDP. However, concerns and doubts surrounding the pandemic and the global economic recovery rate have recently impacted the currency. In our short-term models, external factors explain virtually all of the recent depreciation of the Brazilian real, although our worse performance compared to peers also reflects domestic uncertainties.

Chart 2: Contribution to exchange rate variation
In BRL cents



Domestic factors: CDS, terms of exchange, 1-year interest differential with USA and model error
External factors: DXY and basket of emerging currencies

Source: Bloomberg, Bradesco

Our exchange rate forecast remains between BRL/USD 4.7 and BRL/USD 5.3 for 2021 and 2022. We see signs conducive to the real's appreciation, in response to the fundamentals. In fact, our fair value models continue to indicate a rate around BRL/USD 4.3. However, the balance of risks has proven to be important for the currency's monthly behavior: concerns with a potential postponement of global reopening, restatement of commodity prices to levels closer to fundamentals, and internal uncertainties may remain under the radar.

On the inflation side, new surprises with short-term data have led us to revise our IPCA forecast for this year from 6.4% to 7.1%. The persisting rise in industrial prices, the recomposition of service prices arising from the reopening of the economy, and the current water crisis continue to suggest unfavorable price dynamics this year. There has been some accommodation in commodity prices and exchange rate in recent months, but we have not yet seen a slowdown of industrial goods to consumers. In addition, the reopening of the economy has put more pressure onto service segments than anticipated, as evidenced in the latest IPCA-15 data. Moreover, climate issues have led to an additional increase in food prices in the middle of the year, especially in fresh products.

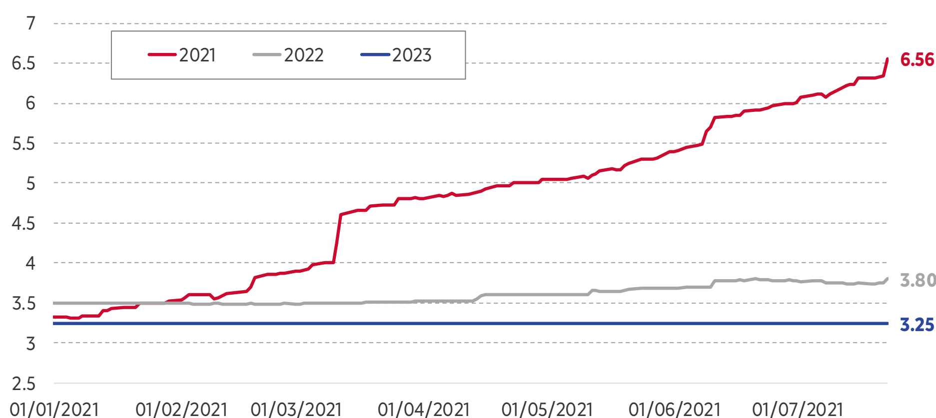
Chart 3: Average core inflation
Annualized changes in 3 and 6 months and 12-month accrual, until the IPCA-15 of July

Source: IBGE, Bradesco

The expected fadeout of these shocks and normalization of the monetary policy should bring inflation to 3.3% in 2022, below the center of the target (3.5%). The perception of such lower inflation in 2022 comes from a set of factors. We are currently going through a major shock in commodities; the real exchange rate is at its most depreciated point in two decades; there is enormous uncertainty regarding the behavior of prices as the economy reopens, and there is a significant accumulation of climate shocks. We do not believe it is likely that these shocks will be repeated in 2022, and there is enough time for them to fade out before next year, amidst a scenario of still relevant idleness in the job market.

Indeed, part of the inflation and the shock stems from the economic policy. There was major fiscal and monetary expansion, resulting in higher demand and stronger exchange rate depreciation. But both of these issues have been reversed and the Central Bank of Brazil has been one of the fastest among its peers to react to inflation. Core inflation itself, typically identified as a secondary shock, has shown an acceleration concentrated in items that are unrelated to the commodities shock and those related to the reopening process. In addition, it is important to note that inflation expectations for one year and one and a half year tend to react significantly to current inflation, therefore not necessarily representing a vector of permanent price deterioration. The worsening of expectations for 2022 has actually been minor compared to the magnitude of the shocks. Therefore, none of these issues seem to be "structural" in this inflation scenario, for now.

Chart 4: Inflation expectations
Focus survey, in %



Source: BCB, Bradesco

In any case, in light of the worsened current inflation and expectations, we believe the Central Bank of Brazil will raise the Selic rate to 7.0% by the end of 2021 and maintain this rate in 2022. The reaction to shocks should take into account their nature, the unprecedented nature of the pandemic and uncertainties they carry over into forecasts, in addition to the risk of spreading, which is apparently low. A more powerful monetary policy, the more incisive discourse of the Central Bank, and the dissipation of current shocks should help prevent the normalization from converging into a conventional monetary tightening process. However, our scenario is based on the following premises: i) maintenance of fiscal achievements of recent years, particularly the spending cap; ii) moderate price realignments during the final phase of economic reopening, which we believe is already quite advanced from a practical standpoint; and iii) confirmation of a shock-free scenario moving forward.

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More balanced global scenario risks

After a few months leaning towards the positive range, the balance of risks of the foreign market is closer to neutrality. The progress of vaccination rollout, reopening of the economy, and fiscal and monetary stimuli resulted in many positive surprises coming from economic data, feeding the risk appetite among investors in the last few months. However, this series of favorable news now seems to be better priced in asset markets. At the same time, there are still concerns that inflation would force central banks to normalize the monetary policy much faster than anticipated. This ultimately led to more balanced risks in the global scenario. In this scenario, investors seem more willing to consider risks that, until recently, had been given less attention.

Chinese stock markets recorded major losses in the past few days, reflecting investors' concerns with regulatory risks. The Chinese government has announced adjustments in some sectors, such as education and technology, prompted by concerns surrounding foreign capital participation, high leverage, data control, and social and labor aspects. This ultimately led to a rising trend in risk aversion, which has contaminated assets of other countries, particularly in stock markets, given the weight of Chinese companies in the funds and indexes of emerging markets.

At the same time, the Chinese economy's performance is still supported by foreign demand, while internal consumption has grown at a more moderate pace, in line with our expectation regarding an economic slowdown. After the compulsory rate cut, the economic policy points towards support to the economy, especially small companies, impacted by higher raw material costs. Therefore, after stimuli were normalized, the policy has been slowly calibrated. We have maintained our growth forecast of 5% and 6% in this second half of the year.

The calibration of stimuli is also a hot topic in the United States. As previously indicated, the Federal Reserve kicked off discussions regarding the normalization of the economic policy. According to the president of the institution, the economy has advanced towards the goals of full employment and inflation stabilized slightly above 2%, but the board believes these objectives have still not been fully reached. Investors should continue to expect the Fed to tread towards normalizing the monetary policy, successfully avoiding a new taper tantrum (market volatility caused by the announcement that the Fed would start tapering its asset purchases in 2013). Therefore, we still expect a strong growth rate in U.S. economy of 7% and 4.4% this year and the next, respectively.

In recent weeks, consumer inflation (measured by the CPI) surprised the market once again, but there is no evidence that inflationary pressures will persist. To assist in this assessment, the Federal Reserve of San Francisco broke down consumer inflation between Covid-19 sensitive and non-sensitive items. By this metric, it is clear that the pandemic has been a determining factor in pressuring inflation.

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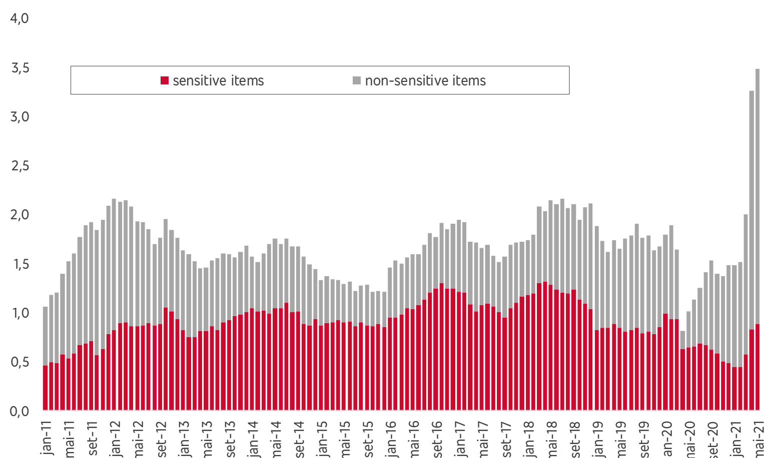
Chart 5: Inflation (PCE deflator) sensitive to Covid-19



Source: Federal Reserve Bank of San Francisco, Bradesco

As long as the data corroborate the argument that the upsurge in inflation is caused by temporary factors, the Fed should maintain the flight plan announced to the market. In the next meeting (or perhaps in the Jackson Hole symposium, to be held in late August), the FED could establish some form of Forward Guidance, indicating adjustments in the asset purchase program (currently at $ 80 billion/month in Treasuries and another $ 40 billion/month in mortgage-backed securities issued by federal agencies in the sector).

In Europe, economic indicators reveal a consolidated recovery trend in the second quarter. As a result, we have not changed our Eurozone GDP growth forecast of 5.0% for this year (and 4.5% for 2022), while the ECB's indication that it is no hurry to withdraw monetary stimuli helps explain why the drop in Treasuries interest was not accompanied by a depreciation of the U.S. dollar against the euro.

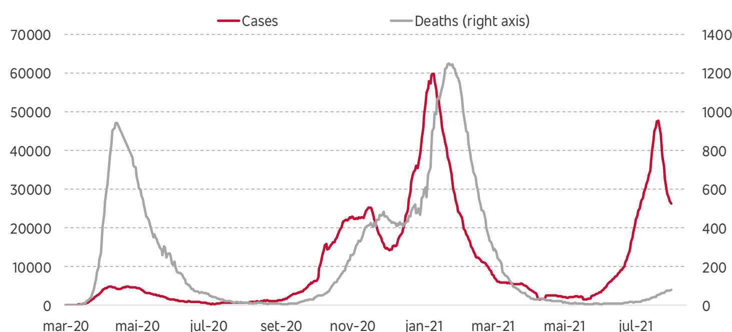
In any case, despite some stability in growth forecasts, the global upsurge in the number of cases of the Delta variant has been the main risk factor in the scenario, including in Europe. The evidence thus far suggests that the greater transmissibility of the new variant leads to an increase in the number of cases, but vaccination apparently grants protection against hospitalizations and severe forms of the disease, keeping mortality rates low.

The Delta variant may also lead investors to differentiate between assets of countries with different vaccination rates. In the UK, for example, where virtually the entire adult population received at least the first jab, the rising number of cases has not proportionally led to an increase in deaths, while in Indonesia, where a much smaller percentage of the population received the vaccine, rising cases were accompanied by an upsurge in deaths.

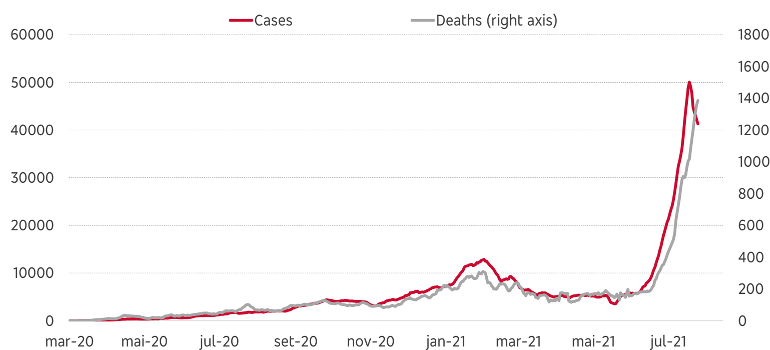
Therefore, once low hospitalization rates in vaccinated countries are confirmed, even amidst a rise in the number of cases, concerns with the Delta variant tend to tone down and ultimately prompt a greater risk appetite in the markets. Specifically, if the rising number of cases does not put pressure on healthcare systems and higher mortality rates, countries with advanced vaccination rollout efforts are likely to maintain the process of economic reopening, maintaining strong growth rates over the next few quarters, even amidst a scenario in which positive surprises with the GDP could be dwindling down.

Chart 6: New cases and deaths by Covid-19

United Kingdom



Indonesia



Source: Bloomberg, Our World In Data, Bradesco

In Latin America, economic data have been positive in general. Argentina perhaps is the main exception, as new social distancing measures were imposed to contain the pandemic. In Peru, president Castillo took office and promised a new constitution and a bigger role of the state in the economy, but still faces a highly fragmented congress. In Mexico, preliminary consumer inflation results for July surprised once again, with a 12-month inflation core reaching 4.6% – its highest level in over three years. The composition of inflation, as well as evidence of economic activity recovery, reinforces expectations that the Central Bank will continue to raise interest rates at the next meeting.

Macroeconomic Projections (2017 – 2022)

	2017	2018	2019	2020	2021*	2022*
DOMESTIC ACTIVITY, INFLATION AND INTEREST RATES						
GDP (%)	1.3	1.8	1.4	-4.1	5.2	2.2
Agriculture (%)	14.2	1.3	0.6	2.0	2.5	1.8
Industry (%)	-0.5	0.7	0.4	-3.5	5.0	2.5
Services (%)	0.8	2.1	1.7	-4.5	4.8	2.2
Private consumption (%)	2.0	2.3	2.2	-5.5	4.6	2.1
Government consumption (%)	-0.7	0.8	-0.4	-4.7	3.0	1.5
Investment (%)	-2.6	5.2	3.4	-0.8	8.5	3.0
Exports of goods and services (%)	4.9	4.1	-2.4	-1.8	8.8	4.0
Imports of goods and services (%)	6.7	7.7	1.1	-10.0	7.6	3.9
GDP (R$ billion - current prices)	6,585	7,004	7,407	7,448	8,482	9,052
GDP (US$ billion)	2,063	1,916	1,878	1,445	1,656	1,761
Population (million)	207.7	209.2	210.7	212.1	213.4	214.7
Per Capita GDP (US$ - current prices)	9,935	9,161	8,914	6,815	7,759	8,198
Industrial Production - IBGE (%)	2.5	1.0	-1.1	-4.5	6.0	2.5
Unemployment Rate - IBGE (%)	12.7	12.3	11.9	13.2	13.8	12.4
Retail Sales - (%)	2.0	2.3	1.9	1.2	5.4	2.2
CPI - IPCA - IBGE (%)	2.95	3.75	4.31	4.52	7.05	3.30
WPI - IGP-M - FGV (%)	-0.52	7.54	7.30	23.14	20.16	4.02
Nominal Interest Rates - Selic target (end of period - %)	7.00	6.50	4.50	2.00	7.00	7.00
Nominal Interest Rates - Selic target (12-month - %)	10.0	6.42	5.9	2.8	4.2	6.9
Real Interest Rates - Selic (12-month - %)	6.8	2.6	1.6	-1.7	-2.7	3.6
EXTERNAL ACCOUNTS AND FX						
Trade Balance (US$ billion)	64.0	53.0	40.5	43.2	76.2	74.3
Exports (US$ billion)	218	240	226	211	287	279
Imports (US$ billion)	154	186	185	167	210	205
Trade flow (exports + imports) (% of GDP)	18.0	22.2	21.9	26.2	30.0	27.5
Current Account Deficit (US$ billions)	-15	-42	-51	-13	12	-2
Current Account Deficit (% of GDP)	-1.1	-2.7	-3.5	-1.7	0.7	-0.1
Foreign Direct Investment (US$ billions)	69	78	69	34	49	61
FX - end of period (R$ / US$)	3.31	3.87	4.03	5.20	4.70	5.30
FX - yearly average (R$ / US$)	3.19	3.65	3.94	5.15	5.12	5.14
Moody's sovereign credit rating	Ba2	Ba2	Ba2	Ba2	-	-
S&P sovereign credit rating	BB	BB-	BB-	BB-	-	-
FISCAL ACCOUNTS						
Primary Surplus (R$ billions)	-111	-108	-62	-703	-131	-87
Primary Surplus (% of GDP)	-1.7	-1.5	-0.8	-9.4	-1.5	-1.0
Gross Public Debt (domestic and external) (% of GDP)	73.7	75.3	74.3	88.8	81.8	82.7
Net Public Debt (domestic and external) (% of GDP)	51.4	52.8	54.6	62.7	60.1	62.3
CREDIT						
Total Credit growth (% YoY)	-0.4	5.1	6.5	15.6	12.0	9.3
Non-earmarked Credit growth (% YoY)	1.9	10.9	14.0	15.4	14.3	12.3

International indicators (2017 – 2022)

	2017	2018	2019	2020	2021*	2022*
GDP						
World	**3.8**	**3.5**	**2.8**	**-3.3**	**6.5**	**4.6**
Developed markets	**2.4**	**2.3**	**1.6**	**-4.8**	**5.8**	**4.1**
United States	2.3	3.0	2.3	-3.5	7.0	4.4
Euro Area	2.3	1.8	1.1	-6.8	5.0	4.5
United Kingdom	1.7	1.4	1.0	-10.2	6.5	5.0
Japan	1.7	0.8	0.9	-4.8	2.5	2.5
Emerging markets	**4.8**	**4.5**	**3.7**	**-2.2**	**6.7**	**5.0**
China	6.9	6.5	6.1	2.3	9.0	5.5
Latin America	1.2	1.0	0.1	-7.2	5.8	3.0

International indicators – Latin America (2017 – 2022)

	2017	2018	2019	2020	2021*	2022*
Argentina						
GDP (%)	2.7	-2.5	-2.2	-11.0	6.0	2.5
CPI (%)	24.8	47.7	53.8	36.1	45.5	39.7
Interest rate (%)	29.20	60.31	44.85	26.95	40.00	37.00
ARS/US$ (end of period)	18.6	37.7	59.9	84.1	119.0	152.0
Brazil						
GDP (%)	1.3	1.8	1.4	-4.1	5.2	2.2
CPI (%)	2.9	3.7	4.3	4.5	7.1	3.3
Interest rate (%)	7.00	6.50	4.50	2.00	7.00	7.00
BRL/US$ (end of period)	3.31	3.87	4.03	5.20	4.70	5.30
Chile						
GDP (%)	1.2	3.9	1.1	-6.0	7.5	3.5
CPI (%)	2.3	2.6	3.0	3.0	3.8	3.0
Interest rate (%)	2.50	2.75	1.75	0.50	1.25	2.25
CLP/US$ (end of period)	615	694	752	712	720	725
Colombia						
GDP (%)	1.4	2.5	3.3	-6.8	5.8	3.5
CPI (%)	4.1	3.2	3.8	1.6	2.8	3.0
Interest rate (%)	4.75	4.25	4.25	1.75	2.25	3.00
COP/US$ (end of period)	2,987	3,250	3,277	3,430	3,685	3,580
Mexico						
GDP (%)	2.1	2.1	-0.1	-8.2	6.0	3.0
CPI (%)	6.8	4.8	2.8	3.2	5.1	3.5
Interest rate (%)	7.25	8.25	7.25	4.25	5.00	5.50
MXN/US$ (end of period)	19.66	19.65	18.93	19.91	19.90	20.50
Peru						
GDP (%)	2.5	4.0	2.2	-11.0	9.0	4.6
CPI (%)	1.4	2.2	1.9	2.0	2.8	2.2
Interest rate (%)	3.25	2.75	2.25	0.25	0.50	1.00
PEN/US$ (end of period)	3.24	3.37	3.31	3.62	3.90	3.70

(*): (estimate)
Source: IMF, Bradesco

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Technical Staff

Director of Economic Research and Studies	Fernando Honorato Barbosa
Economists	Ana Beatriz Moreira dos Santos / Constantin Jancsó / Ederson Luiz Schumanski / Fabiana D'Atri/ Felipe Wajskop França / Myriã Tatiany Neves Bast / Priscila Pacheco Trigo / Renan Bassoli Diniz / Robson Rodrigues Pereira / Thiago Coraucci de Angelis
Interns	Bruna Andreata Valentino / Henrique Monteiro de Souza Rangel / Lorena Pires Sene / Lucas Daniel Duarte / Rafaela de Sousa Silva

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