Economic Report

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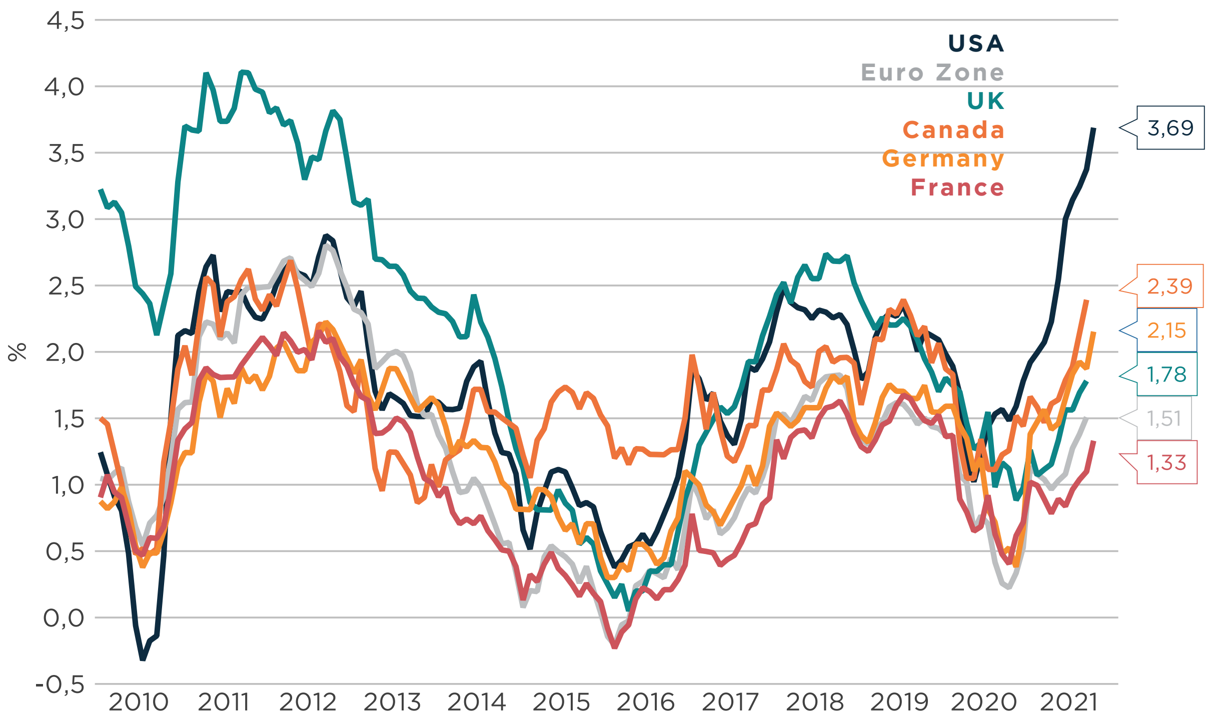
TURIM
MFO

Global: Inflation remains under pressure

Global Economy

Inflation over 2 years annualized



One of the most pressing issues for financial market dynamics has been the discussion on the permanent or temporary nature of the inflation that has affected a number of developed and emerging countries.

The graph shows the two-year annualized variation in consumer price levels in different regions, in order to smooth out the base effect caused by the initial shock from the pandemic. The deterioration in the inflation data can be attributed to shocks in the supply chain but also to the reopening of economies.

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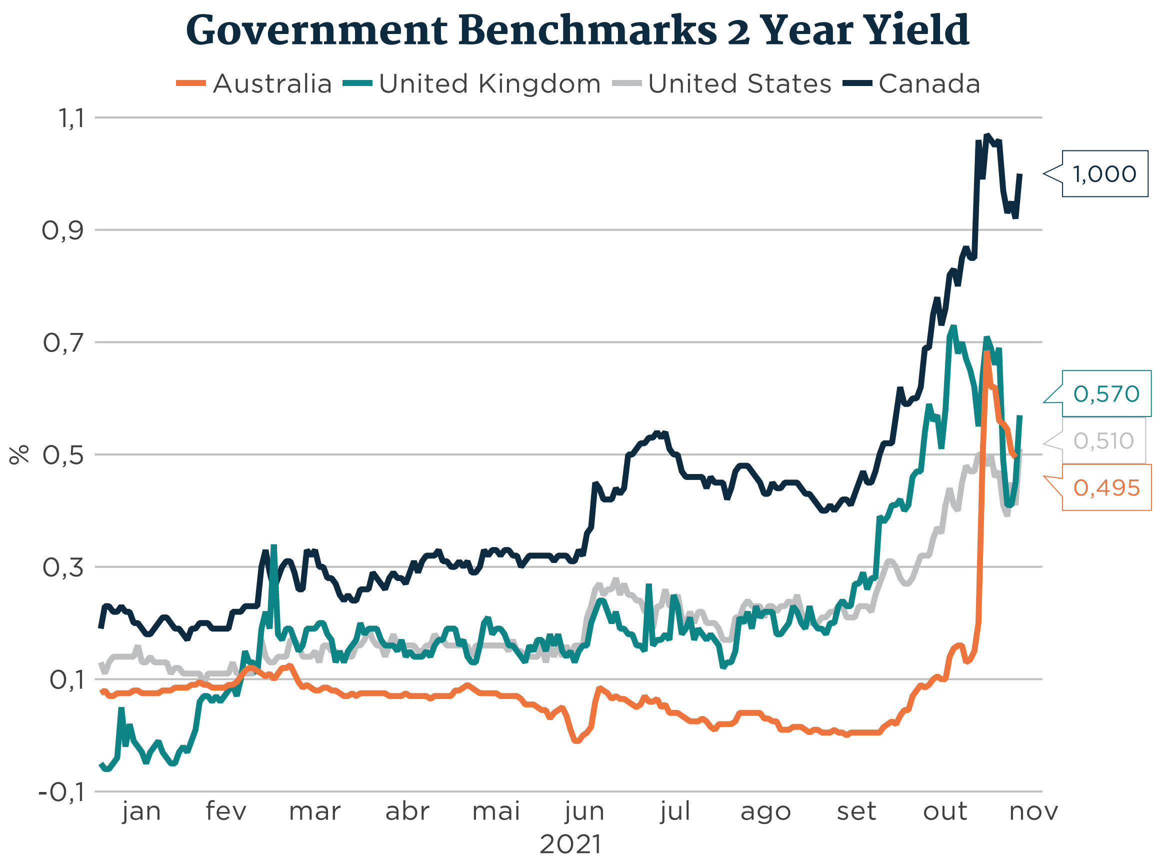
Source: Macrobond

Global: Central Banks alter their tone in relation to inflation

Global Economy



The persistence of stronger-than-expected inflationary pressure has led the main central banks to adopt tighter monetary policies than previously intended.

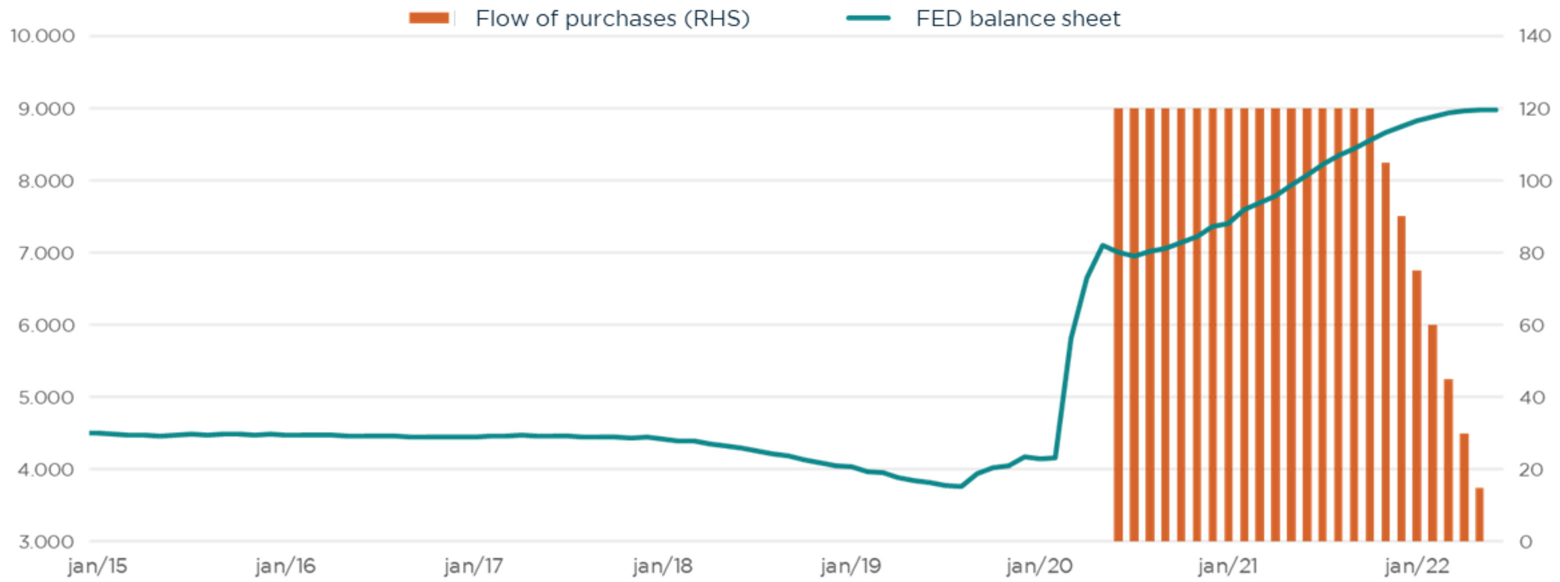
The recent rise in the short-term vertices of the yield curves of some countries helps explain how the market has been responding to the change in policy makers' stance.

Source: Macrobond

US: Asset purchases (QE) should end in mid-2022

Global Economy

Quantitative Easing by the Federal Reserve
US$ billion



As widely expected by the market, the latest meeting of the US Federal Reserve resulted in an announcement of tapering, i.e. reducing the pace of asset purchases by the FED.

As the above graph shows, the end of the FED's liquidity injection program, of around US$ 120 billion a month, should be carried out gradually through the monthly reduction of US$ 15 billion in the pace of purchases. This means the program will end in mid-2022, leaving room for possible interest rate hikes from the second half of the year.

Source: Macrobond e Turim MFO

Fiscal: Spending cap under attack

Brazilian Economy

Impact on the 2022 budget

BRL billion

Items	Impact on 2022* budget	% of GDP
Savings with court orders	44.2	0.49
Gain with recalculation of spending cap	60.0	0.66
Fiscal space freed up PEC	**104.3**	**1.15**
Spending		
Impact of INPC at 9.8%	23.5	0.26
Complement to Bolsa Família program	46.9	0.52
Rapporteur's amendments	17,0	0.19
Other expenditure	19.4	0.21
Cooking gas voucher	6.0	0.07
Subsides for the cultural sector	4.0	0.04
Electoral fund	3.6	0.04
Extension of payroll tax break	5.8	0.06

**IPCA accumulated between January and December*

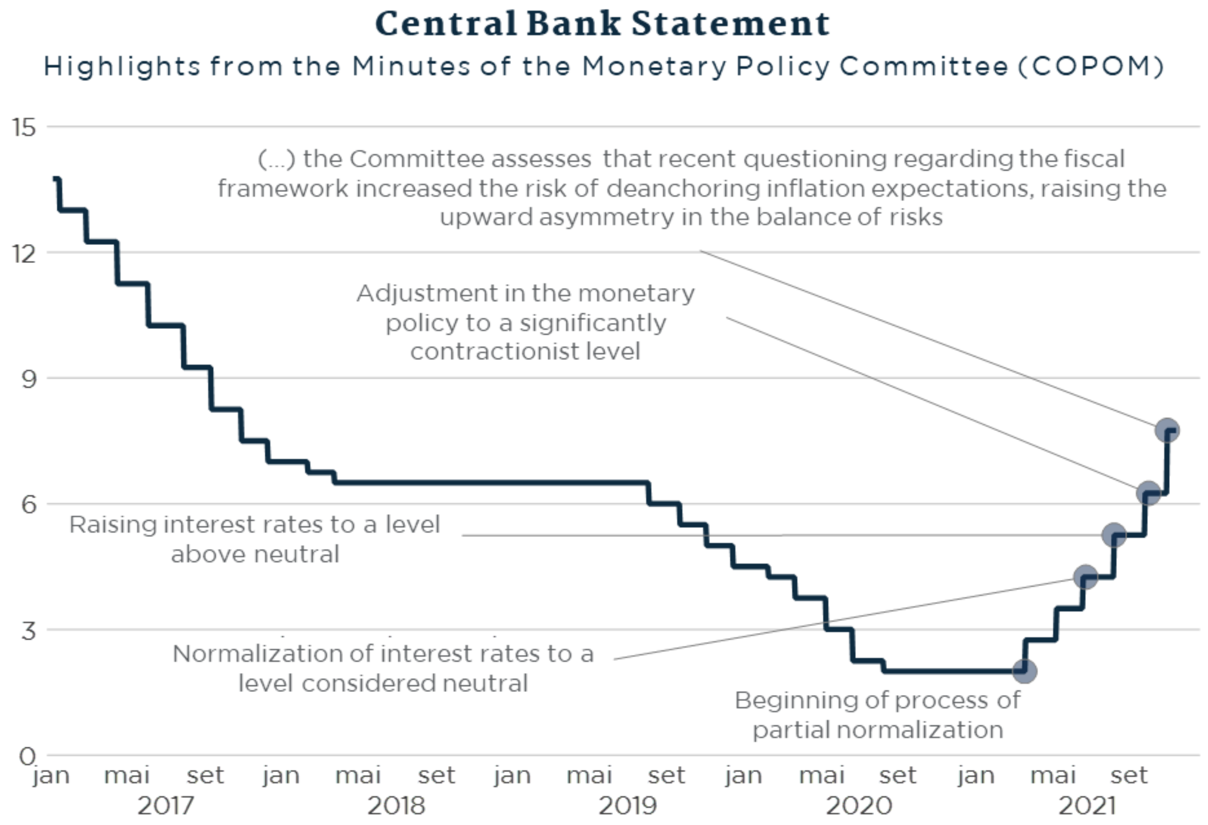
In Brazil, the outcome of the government budget for 2022 has strongly rekindled fears over the country's fiscal sustainability. The solution that was found to allow the government to expand the fiscal space was a change in the indexing factor: the cap that was adjusted by the IPCA inflation index from the middle of the year is now being adjusted by the index from the end of the year.

This is more than a "waiver“ but amounts to an extraordinary expense outside the cap. The change in the rule has more lasting implications as it de-anchors expectations based on the design of the current fiscal framework.

Source: J.P. Morgan

Monetary Policy: Central Bank becomes a “passenger” in the fiscal policy discussions

Brazilian Economy



The deterioration in the fiscal framework also had repercussions on monetary policy decisions. The Central Bank, which was already in a process of raising interest rates, opted to speed up the pace. It hiked rates by 150 basis points* at the October meeting due to the increased risk of de-anchoring inflation expectations caused by uncertainties over the fiscal outlook. With inflation under pressure in the short term, expectations above the target for 2022 and fiscal uncertainty still present, the hawkish stance** should continue in the short term.

*1 basis points or 1 bp= 0.01% ou 1/100 percentage points

**Dovish & Hawkish: These terms are used as a benchmark for the conduct of an economy’s monetary policy. When a Central Bank is “dovish”, there is a downward bias for interest rates. The opposite is the case when it is “hawkish” where there is an upward bias for interest rates.

Source: Macrobond

Interest rates: What is the feasible real interest rate in Brazil?

Brazilian Economy

Primary surplus that stabilizes the Gross Debt/GDP %

Ratio Debt/Initial GDP: 82.1%

GDP Growth \ Interest rate of gross debt	1.0%	1.5%	2.0%	2.5%	3.0%	4.0%	4.5%	5.0%	5.5%	6.0%
1.0%	0.0%	0.4%	0.8%	1.2%	1.6%	2.4%	2.8%	3.3%	3.7%	4.1%
1.5%	-0.4%	0.0%	0.4%	0.8%	1.2%	2.0%	2.4%	2.8%	3.2%	3.6%
2.0%	-0.8%	-0.4%	0.0%	0.4%	0.8%	1.6%	2.0%	2.4%	2.8%	3.2%
2.5%	-1.2%	-0.8%	-0.4%	0.0%	0.4%	1.2%	1.6%	2.0%	2.4%	2.8%
3.0%	-1.6%	-1.2%	-0.8%	-0.4%	0.0%	0.8%	1.2%	1.6%	2.0%	2.4%

Note: Negative numbers are the primary deficit, positive numbers the primary surplus.
Potential privatizations/sales of reserves not considered.

The high real interest rates priced in by the market, due to the uncertainties already mentioned, raise the question of what the feasible real interest rate for Brazil is. In the accompanying table we simulate the primary surplus that would be needed to stabilize the gross debt as a proportion of GDP, subject to different hypotheses of growth and real interest rates.

We believe the incompatibility of the real interest rates currently priced in by the market (around 5.5% in the medium term) with debt stabilization, unless in the case of an aggressive fiscal consolidation leading the country to very positive primary results, could lead to discussions on a scenario of fiscal dominance (when the rise in the basic interest rate is unable to combat inflation, as the public debt is regarded as "unpayable").

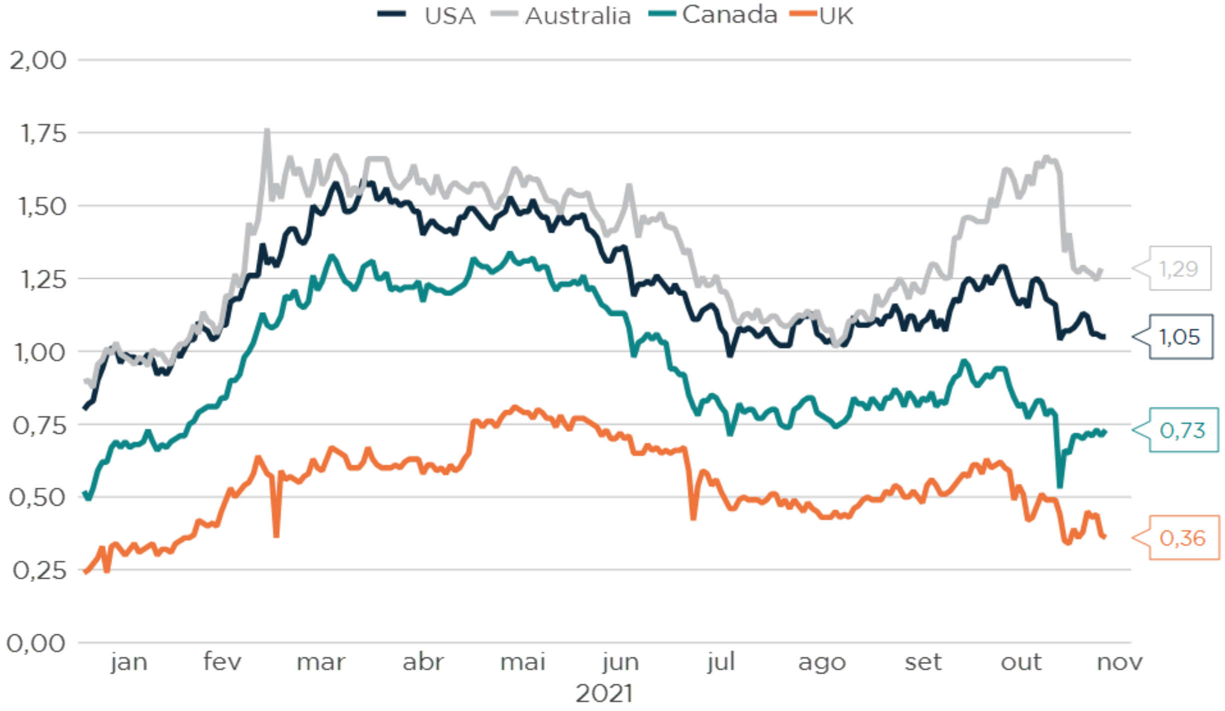
Source: Turim MFO

Interest Rates: Flattening of the curves

Markets

Interest rates slope

Difference between 10 and 2-year public bonds rates



There is a broader movement and not just a rise in yield curves short-term vertices leading to a reduction in slope, i.e. a narrower spread between long and short-term rates. The graph shows that the difference between the 10 and 2 year vertices fell in October in a number of countries.

Although this movement partly reflects a technical factor (this month some funds that had been betting on the increase in the slope liquidated large positions), it also highlights the view that, even with slightly more hawkish central banks, the market is still pricing in the idea that we are experiencing a regime of structurally low interest rates.

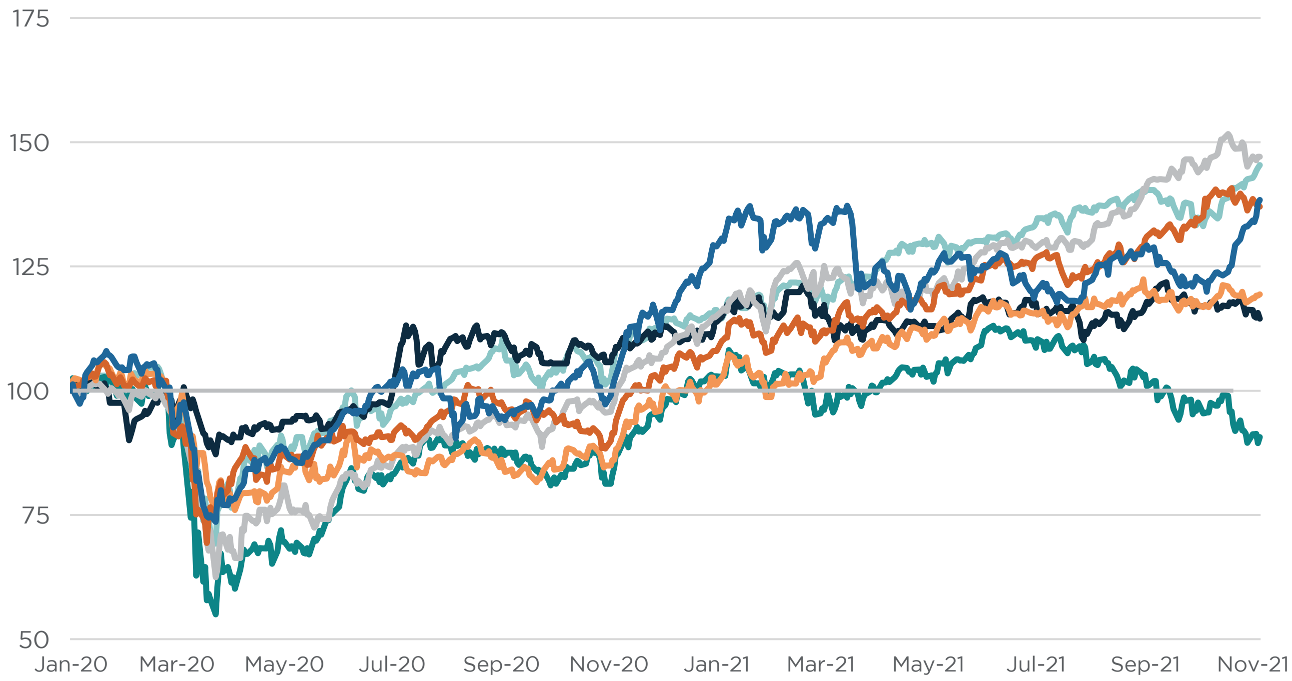
Source: Macrobond

Stock Market: Fiscal chatter sets Ibovespa on opposite path from global markets

Markets

Return of Stock Market Indexes

Base 100 = 2020



Accumulated Return in Year in Local Currency

US	Brazil	China	India	Mexico	Russia	Turkey
22.6%	-13.0%	2.1%	26.4%	16.4%	26.2%	3.1%

Despite the favorable external outlook, the uncertainties on the fiscal front had a strong impact on domestic risk assets, including the stock market. The Ibovespa was marked by another month of steep falls despite the strong performance of global stock markets, including those of emerging countries.

Source: Bloomberg e Turim MFO

Interest rates: Curve inverts in Brazil

Markets

Brazilian interest rates curve slope

Difference between DIs maturing in Jan/27 and Jan/23

Source: Bloomberg

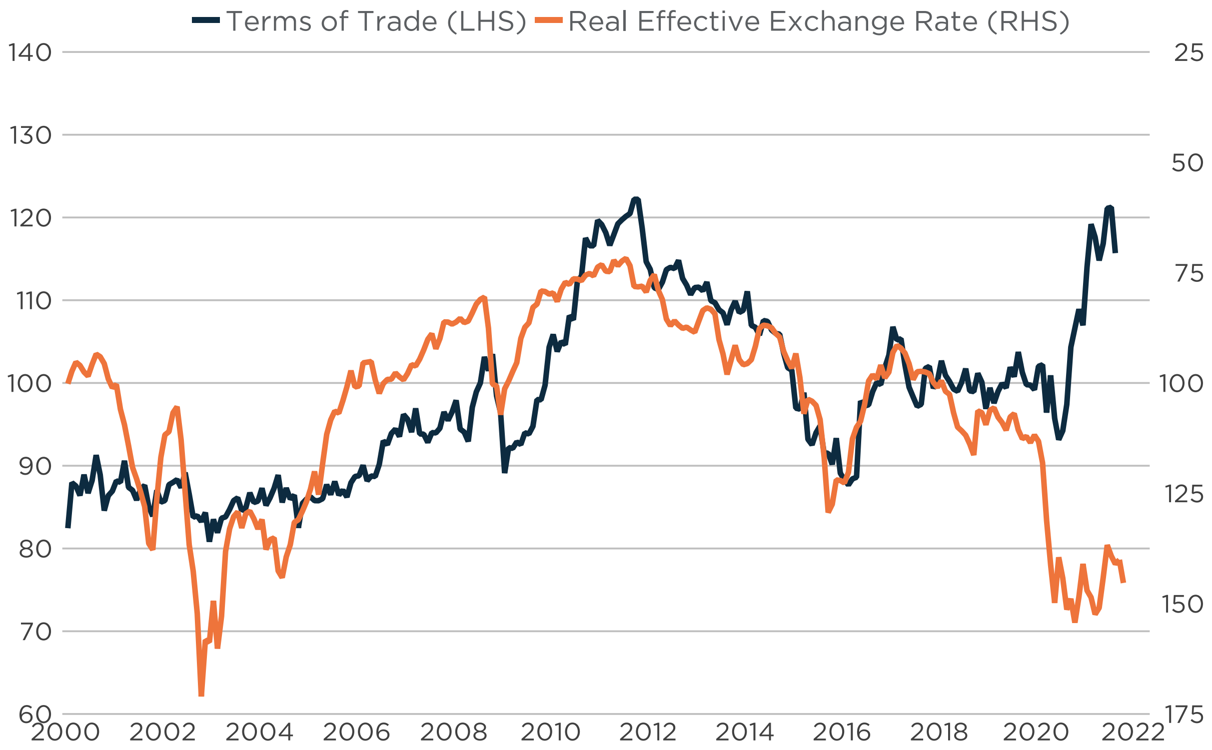
The flattening movement seen in the rest of the world was far more intense in Brazil, even resulting in its inversion. This can be seen in the difference between the DIs future interest rate contracts maturing in January 2027 and January 2023, as shown in the graph.

This inversion reflects not only the global component but also the Central Bank's more aggressive stance, with an acceleration in the pace of interest rate hikes and the fear that this could lead to a recession as soon as next year, forcing the monetary authority to start a cycle of interest rate cuts immediately afterwards.

Exchange Rate: Despite the (still) higher terms of trade the BRL remains undervalued

Markets

Real Effective Exchange Rate and Terms of Trade



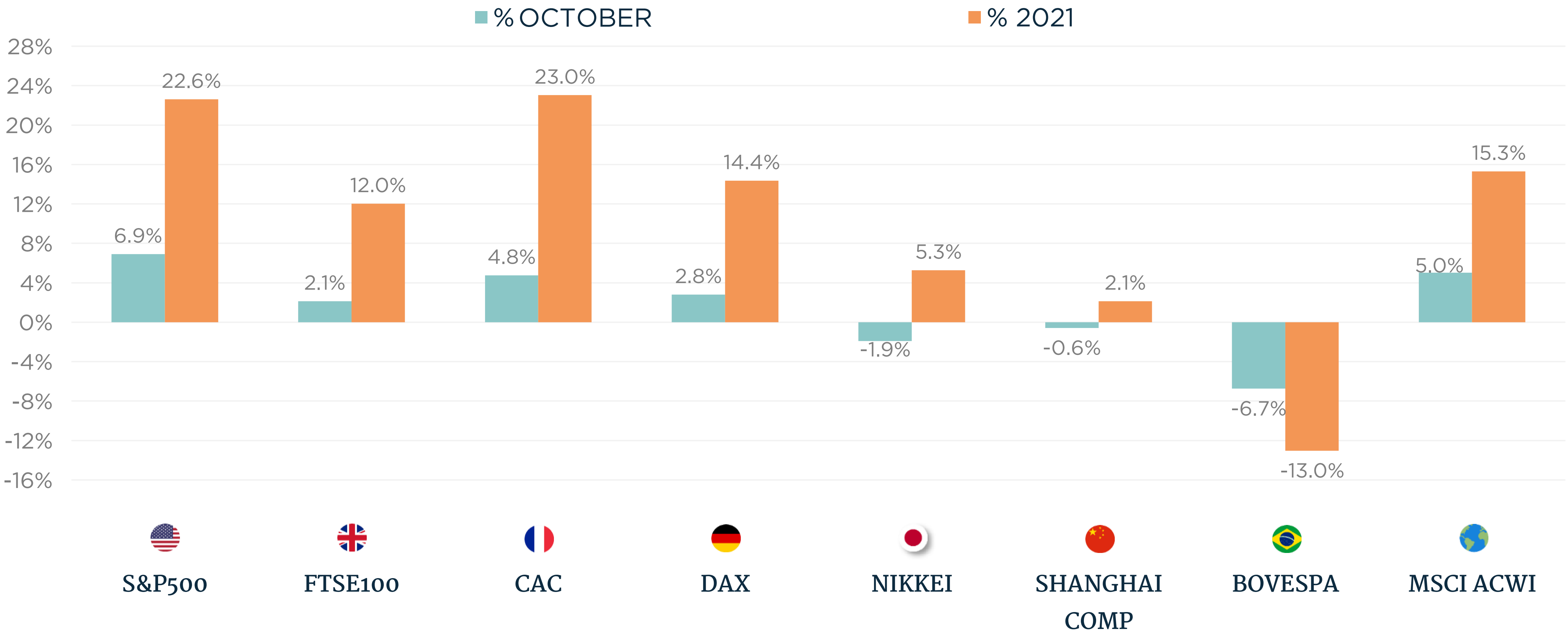
The graph shows the strong long-term correlation between the real effective exchange rate and the terms of trade of the balance of trade (ratio between the prices of the country's exports and imports): an improvement in the terms of trade usually favors an appreciation of the exchange rate.

However, this correlation has been abruptly interrupted since the pandemic, as the Real has depreciated despite the increase in commodity prices. Although the Selic rate which has been at historically low levels over the last few quarters has been a contributory factor, the main reason for this movement is the increased fiscal uncertainty in Brazil.

Source: Macrobond

Stock Markets

Markets



Indexes

	% October	Value on 29/10/2021	% 2021	% 12 months
COMMODITIES				
OIL WTI	11.4%	83.57	72.2%	133.5%
GOLD	1.5%	1,783.38	-6.1%	-5.1%
CURRENCIES (IN RELATION TO THE US$)				
EURO	-0.2%	1.16	-5.4%	-0.8%
GBP	1.5%	1.37	0.1%	5.7%
YEN	-2.3%	113.95	-9.4%	-8.2%
REAL	-3.4%	5.64	-7.8%	1.9%
ÍNDEXES				
S&P500	6.9%	4,605.38	22.6%	40.8%
FTSE100	2.1%	7,237.57	12.0%	29.8%
CAC	4.8%	6,830.34	23.0%	48.7%
DAX	2.8%	15,688.77	14.4%	35.8%
NIKKEI	-1.9%	28,892.69	5.3%	25.7%
SHANGHAI COMP	-0.6%	3,547.34	2.1%	10.0%
BOVESPA	-6.7%	103,500.70	-13.0%	10.2%
MSCI ACWI	5.0%	745.23	15.3%	35.3%

*Amounts and results in local currencies

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