# Macro Monthly Letter

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# Restrictive Financial Conditions

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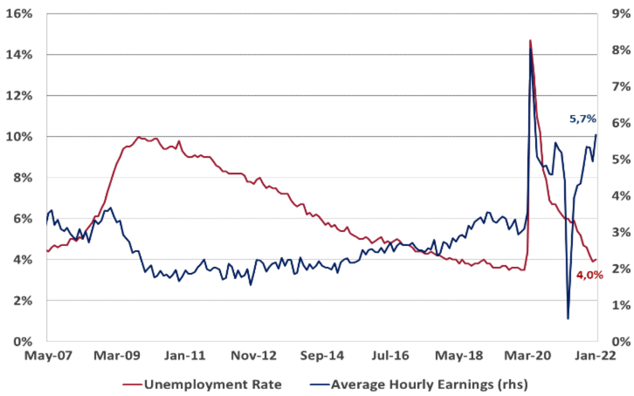
The last Federal Open Market Committee outlined more details on the monetary policy tightening of the American economy, with clear indications of a strong increase in interest rates and a reduction of the Fed's balance sheet in the near future. During the pandemic, the Fed accumulated assets through the purchase of treasury bonds and mortgage-backed securities, and now, inflation numbers, which remain high, and an extremely heated labor market, are worrisome enough to bring in the balance sheet run-off an additional monetary policy instrument.

According to the announced principles, the Fed Fund rate remains the main policy instrument, and in March, when the Fed stops buying treasury bonds, rate hikes become expected. The reduction of the asset balance, in turn, will only start after the beginning of the process of raising interest rates. The pace, the size and the beginning of the balance sheet run-off are not yet defined, but there are indications that the adjustment should happen quickly. The message given in the press conference of the last decision was clear: compared to 2015, the economy is stronger, the labor market is tight, and inflation has been running above 2% for a long time.

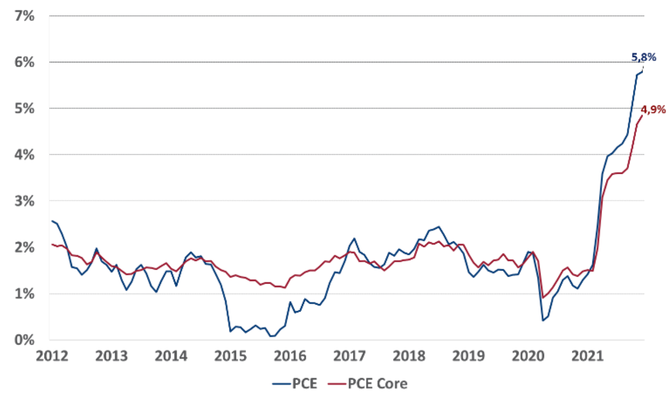
**Figure 1 - US: Unemployment Rate vs Average Hourly Earnings (YoY, %)**




Source: Bocom BBM, BLS

The resilience of the U.S. economy in light of the resurgence of the pandemic with the Omicron variant is evident in labor market data, which continue to point to job creation above market expectations in the segments of services, commerce, and transportation, most favored by the reopening of the economy and increased mobility. In response to a demand for labor that continues to exceed the supply, the average hourly wage increased 5.7% in 12 months (FIGURE 1), putting more pressure on U.S. inflation. Core PCE inflation reached 4.9% in 12 months (FIGURE 2), and its extended permanence above the 2% target provides support for the FOMC to make the first interest rate increase already in March, with market expectations of five hikes over 2022, bringing the rate to 1.25-1.5% by year-end.

Figure 2 - US: PCE SA (YoY, %)

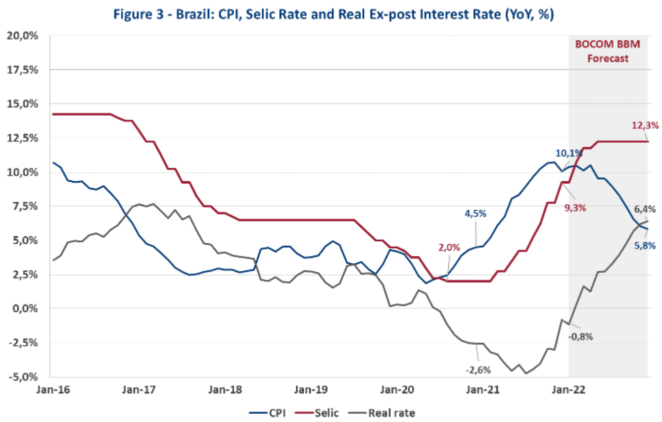



Source: Bocom BBM, BEA

In Europe, the Central Bank of England (BoE) raised the interest rate by 25 bps to 0.5%, recognizing inflationary risks also in the British economy, in a fierce decision, in which 4 of the 9 members of the monetary policy committee voted for an even greater increase of 50bps. In line with the U.S. and British Central Banks, the European Central Bank (ECB) has now recognized the need to recalibrate its monetary policy in response to a 5.1% inflation in the latest disclosure, substantially above the 2% target, which should accelerate plans for reducing asset purchases, consistent with the scenario of an interest rate hike still at the end of 2022.

The hawkish tone of the world's major central banks dictates the pace of monetary tightening that will be necessary to combat inflation in developed economies, bringing even more challenging financial conditions to emerging economies. Higher volatility in asset prices, exchange rate in particular, puts even more complexity in the inflation scenario and monetary policy decision in Brazil.

Here in Brazil, monetary policy remains contractionary, accumulating eight straight hikes since the beginning of the cycle in March 2021. In its last meeting, the Monetary Policy Committee raised Selic by 150bps – reaching 10.75% per year – but signaled a reduction in the pace of interest rate hikes for the next meetings. We projected an increase of over 100bps at the March meeting, followed by another 50bps hike in May, reaching 12.25% at the end of the cycle (FIGURE 3). This interest rate trajectory is consistent with the inflation's convergence to the target in the relevant horizon, which from April on will focus 2023, according to the projections of the Central Bank.




Source: Bocom BBM, IBGE, BCB

There are, however, risks in this desinflationary process. On the one hand, the slowdown in domestic activity, coupled with idleness in the labor market, and a greater sensitivity of the economy to changes in interest rates, such as the expansion of the private credit market and the end of subsidized credit, are a downward risk for inflation. On the other hand, more restrictive international financial conditions and uncertainties brought in the election year are an upward risk. Below are our updated projections for 2022 and 2023.

Our projections for 2022 are shown below.

| ECONOMIC FORECASTS | 2019 | 2020 | 2021F | 2022F | 2023F |
|---|---|---|---|---|---|
| GDP Growth (%) | 1,1% | -4,1% | 4,4% | 0,3% | 1,7% |
| Inflation (%) | 4,3% | 4,5% | 10,1% | 5,8% | 3,3% |
| Unemployment Rate, SA (eoy ,%) | 11,7% | 13,9% | 11,5% | 13,2% | 13,0% |
| Policy Rate (eoy, %) | 4,50% | 2,00% | 9,25% | 12,25% | 8,00% |
| **External Accounts** | | | | | |
| Trade Balance (US$ bn) | 48 | 32 | 36 | 49 | 40 |
| Current Account Balance (US$ bn) | -65 | -24 | -28 | -23 | -43 |
| Current Account Balance (% of GDP) | -2,8% | -0,9% | -1,8% | -1,3% | -2,6% |
| **Fiscal Policy** | | | | | |
| Central Government Primary Balance (% of GDP) | -1,2% | -10,0% | -0,4% | -1,4% | -1,3% |
| Government Gross Debt (% of GDP) | 74,3% | 88,8% | 80,3% | 82,1% | 87,1% |