ECONOMICS **August 4, 2016**

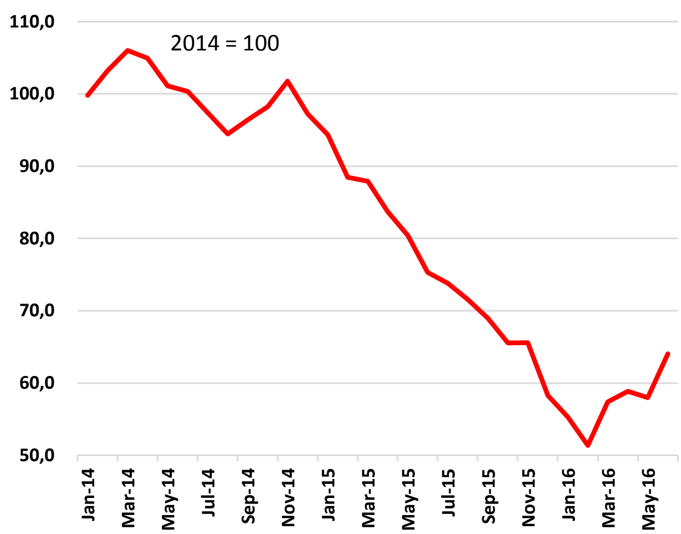
Brazil—Economic Activity

It's Happening: The Ongoing Investment-Led Recovery

Maurício Molan*
mmolan@santander.com.br
5511-3012-5726

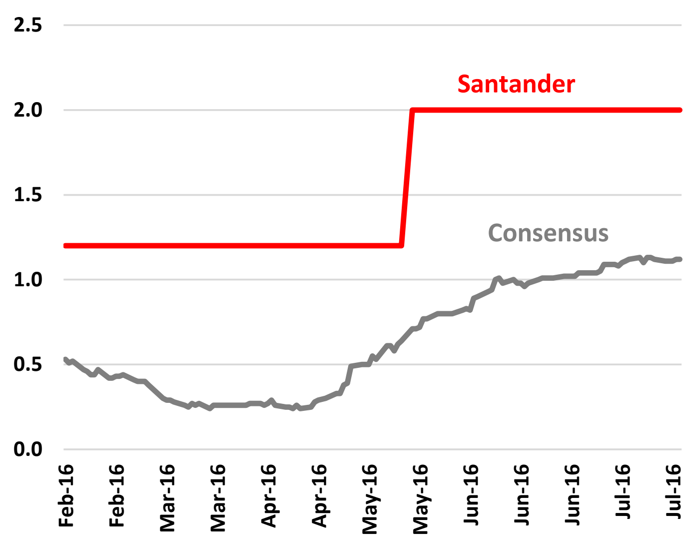
- **We have been maintaining that high levels of spare capacity in the Brazilian economy will not be an impediment to an investment-led recovery of GDP (see our report *Ladder or Trapdoor*, June 28, 2016).**
- **According to historical experience, most of the recoveries from deep recessions in Brazil have been based on investments.**
- **So far, economic activity indicators also seem to confirm this call. Although current capacity utilization in the manufacturing sector is still around historical lows, domestic absorption of capital goods has been showing a meaningful recovery in recent months.**
- **Moreover, we see reasons for this trend to be sustained: market and business confidence continue to improve, and we believe financial conditions should turn more favorable in 2017.**
- **We are not claiming that the recovery will be intense and sustainable, or that Brazil is entering a new phase of accelerated and sustainable economic growth. Rather, our aim is to show that both historical and current data suggest that consensus estimates for GDP growth in the period 2016-17 will likely continue to be revised upward.**
- **The most important risks to this process, in our view, are (i) a still excessively precarious public sector debt dynamic, a challenge to the consolidation of confidence; and (ii) excessive strengthening of the BRL that could affect net exports, one of the main drivers, in our view of a potential resurgence in manufacturing.**

Domestic Absorption of Capital Goods Seasonally Adjusted (3 months moving average, 2014 = 100)



Sources: MCM Consultores and Santander.

2017 GDP Growth Forecasts (%)



Sources: IBGE and Santander.

Introduction

We have been arguing that investments will play a major role in a Brazilian economic recovery, chiefly as a consequence of a consistent decline in risk perception and a meaningful reduction in real interest rates (*Ladder or Trapdoor*, June 28, 2016). We recognize that the current low levels of capacity utilization will prevent a faster, stronger, and sustainable expansion, but we do not believe they constitute an impediment to a decent recovery of investments and GDP in the near future.

In our view, there is important variability of capacity utilization across regions and sectors, which means that weak readings for the average do not necessarily translate into an overall absence of the intention to expand production capacity. Moreover, we believe that a non-negligible part of overall investment reduction during the crisis resulted from postponement of projects, which tend to be reintroduced once confidence starts to recover.

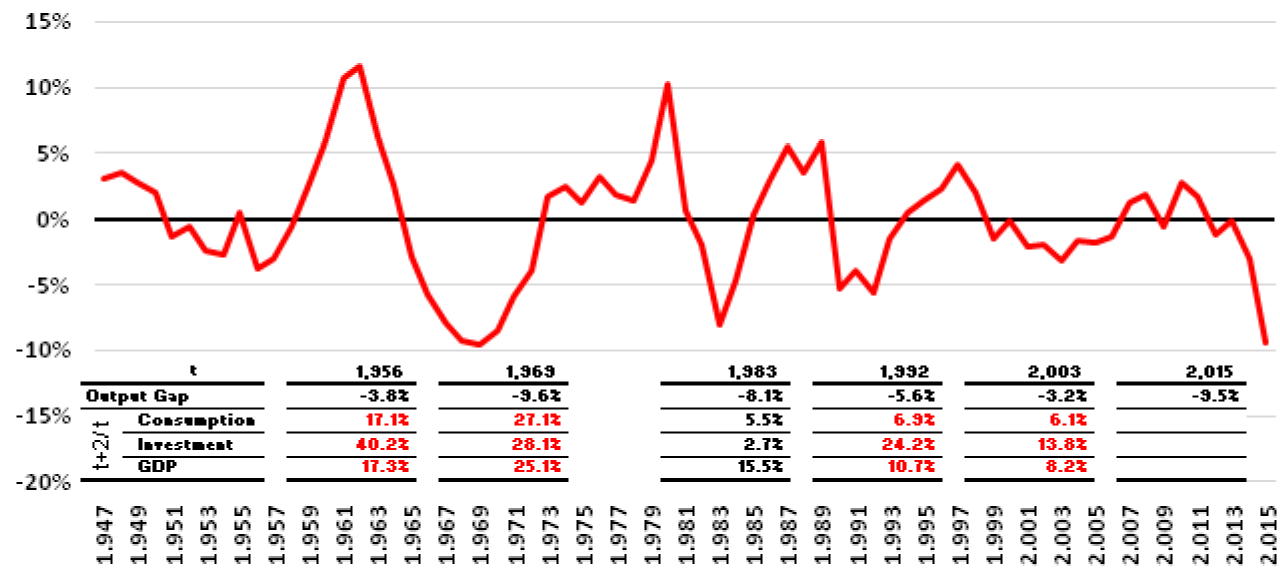
In this piece we discuss what we believe to be important signs that investment already seems to be picking up in the manufacturing sector. Moreover, what we consider as the main drivers for this movement (notably confidence and financial conditions) continue to improve, which suggests that there still is room for further improvement of consensus expectations for the expansion of GDP in 2016 and 2017.

History Shows that Idle Capacity is not Necessarily an Impediment to Investments

Conventional wisdom tends to suggest that investments should take place only after (or slightly before) production factors are in full utilization. If this were true, then all domestic demand recoveries after deep recessions would necessarily be driven by consumption, instead of investments. This idea does not appear to be consistent with the data, though.

The following chart shows a simple estimate of the output gap[1] (a proxy of production factors utilization) highlighting five episodes in which production factors utilization may have been very low. In four of these, existing idle capacity appears not to have been an impediment for meaningful expansion of investments ahead of consumption.

Output Gap (Current GDP / Potential) and GDP Components Expansion Accumulated Two Years After



	t	1,956	1,969	1,983	1,992	2,003	2,015
	Output Gap	-3.8%	-9.6%	-8.1%	-5.6%	-3.2%	-9.5%
t+2/t	Consumption	17.1%	27.1%	5.5%	6.9%	6.1%	
	Investment	40.2%	28.1%	2.7%	24.2%	13.8%	
	GDP	17.3%	25.1%	15.5%	10.7%	8.2%	

Sources: IPEA and Santander.

In fact, we see that, with the exception of 1983, investments have outpaced consumption, expanding by a large margin in the two years after the output gap has achieved its lows.

[1] We used here a simple Hodrick-Prescott filter to estimate potential GDP.

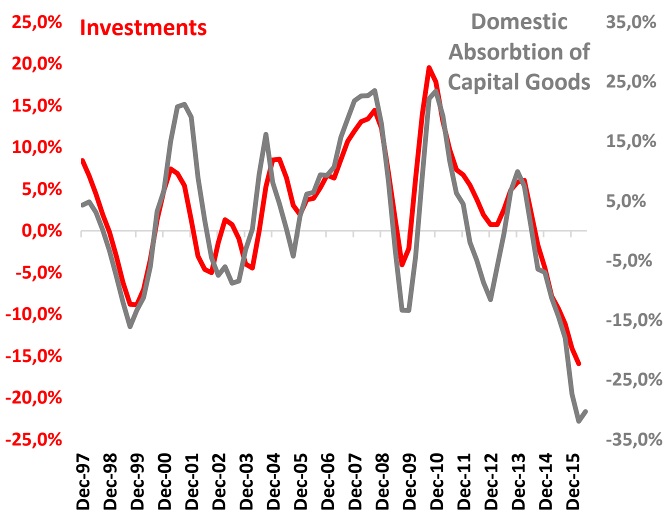
Current Data Suggest Ongoing Investment Recovery

Recent readings of industrial production suggest not only that the sector appears to have bottomed out in 1Q16 and begun recovering thereafter, but also that the recent pick-up is already characterized by a decent recovery of investment. Although we do not yet have data on overall investments for national accounts, this conclusion can be drawn by referring to the dynamic of domestic absorption of machinery and equipment (production + imports – exports).

The chart on the left-hand side below shows the relationship between our proxy and the national account statistics of investment. Here we see the inflection of domestic absorption of capital goods at the margin. Although this indicator is still only 35% of the average of 2014, there has been an increase of 11% in 2Q16, compared to 1Q16, which is far from negligible.

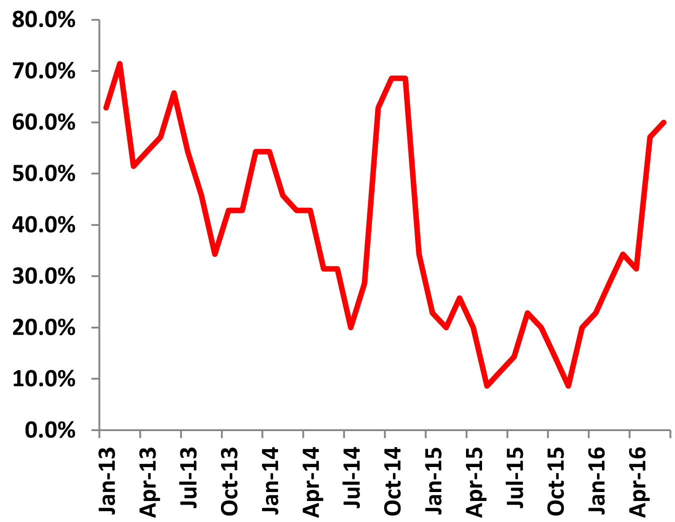
The recent recovery of the diffusion index (the chart on the right), which measures the share of manufacturing activities posting positive output variation in a quarter, reinforces our view of a more broad-based expansion, which may help sustain demand for capital goods.

Investments and Domestic Absorption of Capital Goods (% variation in 12 months)



Source: IBGE, Santander and MCM Consultores.

Manufacturing Sector Diffusion Index (% of Activities (out of 35) Expanding Production (SA) in the Quarter)



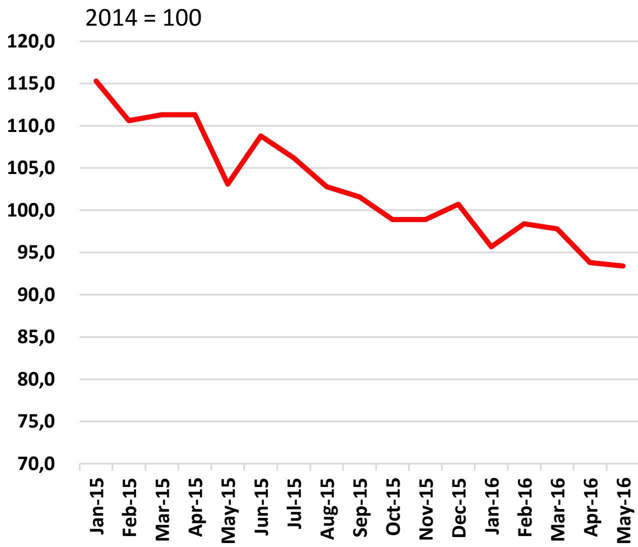
Source: IBGE and Santander.

At this point, it is important to acknowledge that, although we are probably seeing the initial stages of recovery in the manufacturing sector, the same cannot be said about construction, which comprises an important part of overall investments in the economy. In contrast to the manufacturing industry, both production and sales of construction materials show that, although the sector appears to have bottomed out, there are no signs of expansion at the margin.

Clearly, the consolidation of an investment-based recovery requires a meaningful contribution from construction. The bad news is that we do not expect this sector to show signs of life during 2016. We believe that a meaningful recovery will likely occur with a lag of around 6 to 9 months after GDP recovery, and likely coinciding with the inflection of labor markets and credit. This suggests that we will have to wait until mid-2017 to see positive figures for employment and real estate.

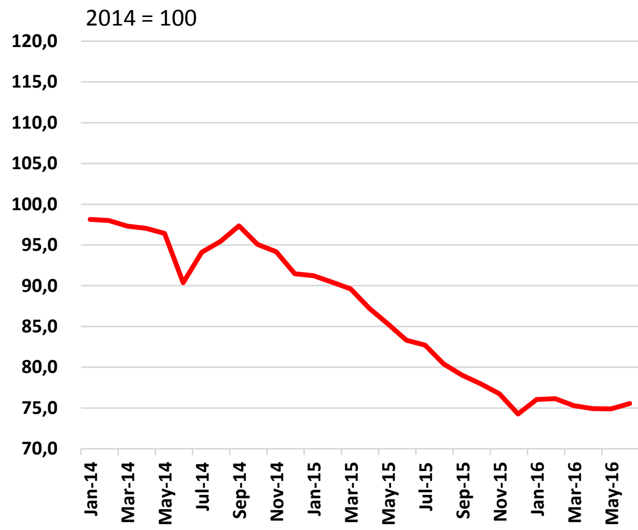
However, the mere fact that construction has ceased its downward trend should be seen as positive. A non-negative performance of construction, coupled with positive investments in the manufacturing sector, will likely lead to a positive variation for investments during 2H16, in our view.

Retail Sales – Construction Material (Seasonally Adjusted, 2014 = 100)



Source: IBGE.

Production of Construction Material (Seasonally Adjusted, 2014 =100)



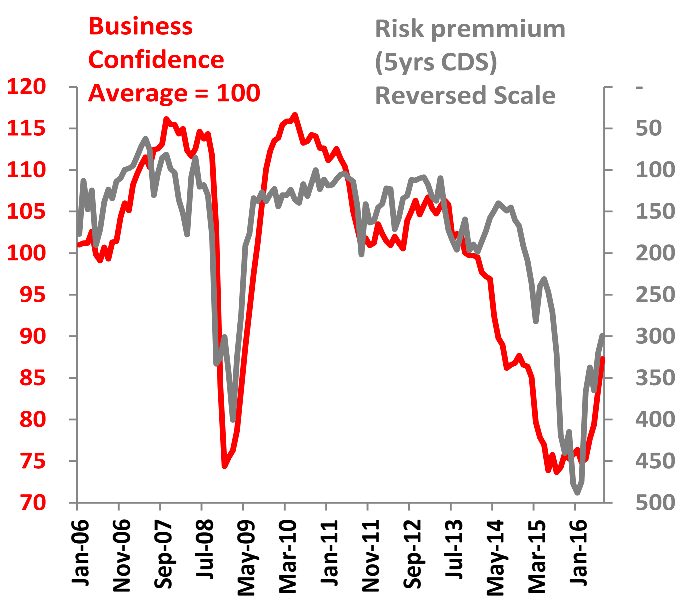
Source: IBGE.

Drivers Expected to Continue Evolving Favorably, Despite Serious Risk Factors

When considering the favorable dynamics of the manufacturing sector, one could argue that the recent trend has been merely a short-term oscillation, rather than an early-stage recovery. We see a couple factors suggesting the opposite, leading us to believe that industrial production will continue trending north.

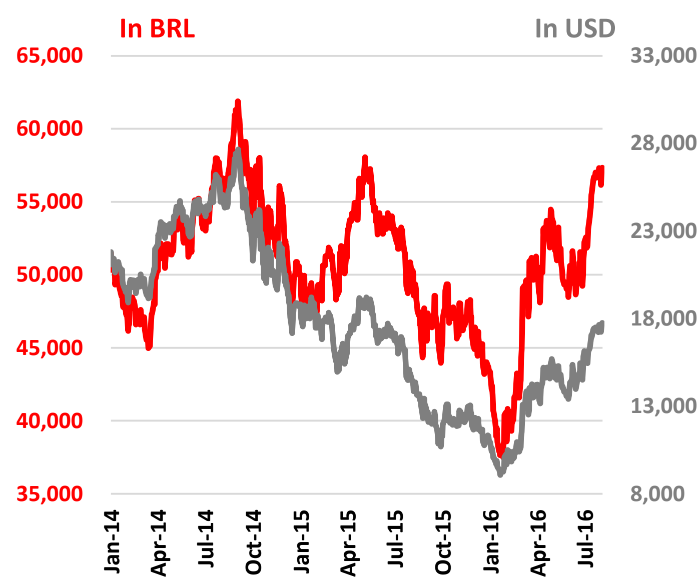
First, among various drivers, we have been emphasizing the importance of confidence for the recovery process. In this sense, we continue to see an important reduction of skepticism regarding the Brazilian economy. Indicators such as business confidence and risk premiums (the chart below on the left-hand side), as well as the performance of equity markets (the chart below on the right-hand side) – leading indicators of economic activity – remain favorable.

Business Confidence and Risk Premium



Source: FGV.

Brazil - Equity Market Ibovespa



Source: Bloomberg.

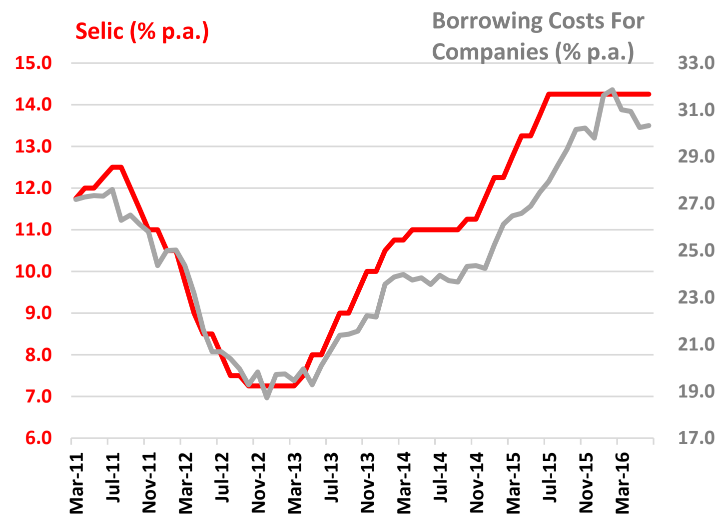
The most important risk factor, in this respect, is the ongoing unfavorable debt-to-GDP dynamic (see *Fiscal X ray*, July 14, 2016). Brazil has yet to build a fiscal framework that would allow for debt stability/reduction. So far, improved confidence has been fully based on the proposals and perceived credibility of policymakers. As such, an economic recovery will remain dependent on the assessment of the market and the business community regarding Brazil's solvency. In this sense, global risk aversion and liquidity conditions will likely continue to play a major role (see *Exchange Rate: The External Factor*, May 25, 2016). By the same token, a meaningful and sustainable recovery will require the substantial evolution of a challenging agenda of fiscal and social security reforms.

Second, we see ample room for additional improvement of financial conditions in Brazil, driven largely by a substantial reduction of the base rate, which is expected to take place over the next 18 months. Long-term interest rates have already fallen substantially ahead of anticipated monetary policy easing and on greater confidence for an improvement on the fiscal front (the chart on the left-hand side). We believe this will likely re-open capital markets for companies to finance their investments. Furthermore, the reduction of the base rate will help alleviate companies' debt burdens, given that the Selic is closely related to the cost of bank debt. A back-of-the-envelope estimation (the chart on the right-hand side) suggests that the Selic falling back to 10% p.a. next year (our forecast) could immediately reduce borrowing costs by some 8 p.p. per year.

Interest Rate
Jan 21 BMF (% p.a.)

Source: FGV.

Base rate (Selic) and Companies Borrowing Costs



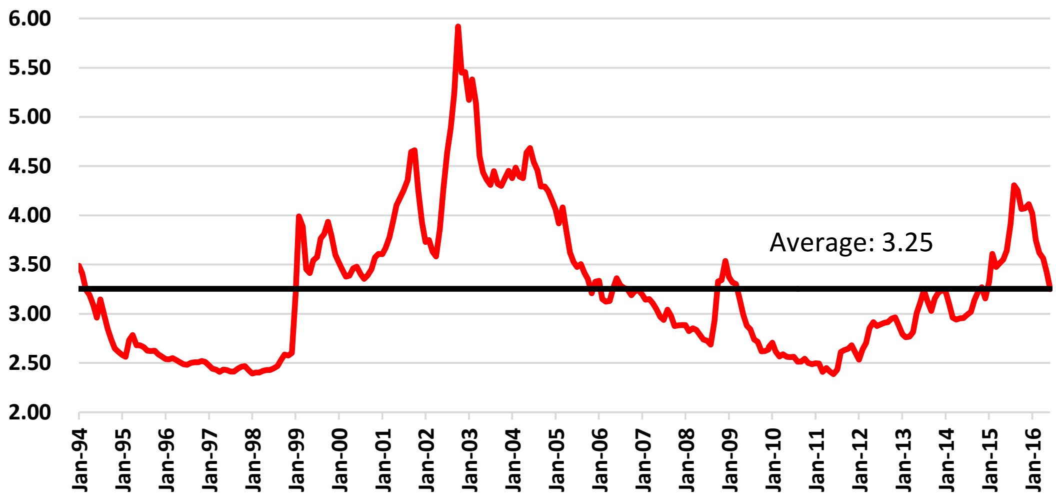
Source: Bloomberg.

An important source of risk associated with this view is, of course, the potential for a different path for the Selic rate than the one embedded in our scenario. But considering the current state of output gap and the ongoing downward trend for inflation, we see as unlikely a scenario in which the base rate does not fall meaningfully in 2017.

But an even risker aspect is an eventual overvaluation of the BRL, considering that net exports, apart from confidence and financial conditions, have been crucial to the recovery of the manufacturing sector.

Given that fundamentals related to competitiveness in Brazil cannot be considered strong and that uncertainties regarding public sector solvency are tremendous, we do not think a stronger-than-historical average real exchange rate would be sustainable in a medium-term perspective. For this reason, in spite of the recent strengthening, we continue to forecast the BRL at 3.65 / USD by the end of 2016.

Real Exchange Rate (BRL x Basket of Currencies at Constant Jul/ 2016 prices)



Source: FGV.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Brendan Hurley	Economist - Colombia	bhurley@santander.us	212-350-0733
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537

Fixed Income Research

David Duong	Macro, Rates & FX Strategy – Brazil, Peru	dduong@santander.us	212-407-0979
Brendan Hurley	Macro, Rates & FX Strategy – Colombia, Mexico	bhurley@santander.us	212-350-0733
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Nicolas Kohn*	Macro, Rates & FX Strategy - LatAm	nicolas.kohn@santandergbm.com	4420-7756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978

Equity Research

Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

Electronic Media

Bloomberg	SIEQ <GO>
Reuters	Pages SISEMA through SISEMZ

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Maurício Molan*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.