

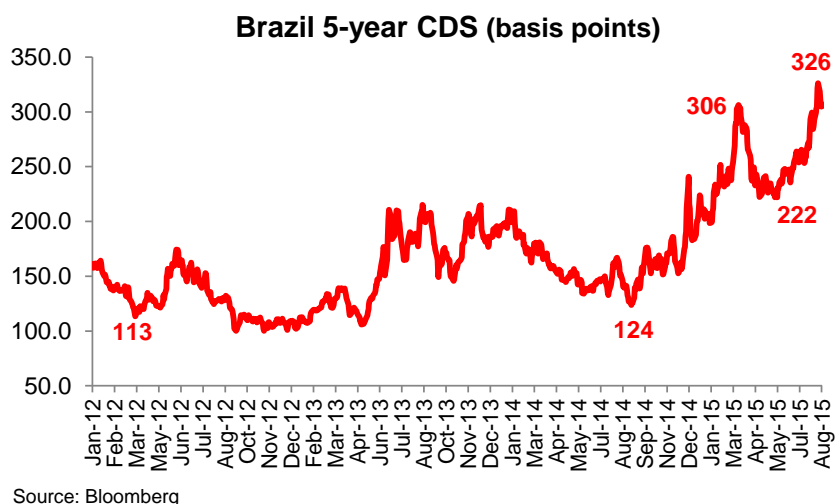
Brazil – Economic Activity**Looking for the Turning Point****Rodolfo Margato***rodolfo.silva@santander.com.br
5511-3553-1859

- In our view, reversion of the current downward trend of the GDP is mostly dependent on: (1) the impact of the BRL depreciation on economic activity, (2) monetary policy easing expected for 2016, and (3) confidence.
- In this piece, we focus on business confidence. We view the sovereign risk premium (measured by five-year CDS) as a good leading indicator for the overall mood of corporations and willingness to invest.
- We believe the sharp rise of CDS in recent weeks, mostly driven by weaker prospects regarding the fiscal adjustment and continuing political turmoil, will lead to a longer-than-expected persistence of the recessionary outlook.
- The stabilization or reduction of the risk premium is a necessary condition, in our view, for an improvement in business confidence and a recovery of investments in a time horizon of six to nine months.
- Our base case scenario assumes CDS levels will fall from the current exaggerated levels through the beginning of next year. See *Persistent Uncertainties*, August 21, 2015, and *How Much Is Too Much for the BRL and the Selic?* July 30, 2015.
- With this, we believe business confidence will gradually recover from late 2Q16 onward, driving economic activity to grow consistently only in 2H16.
- We revised downward our expectation for GDP growth this year to -2.3% from -1.9% (see *Persistent Uncertainties*, August 21, 2015). For 2016, we now expect a 0.5% decrease in GDP (previous: +0.1%).

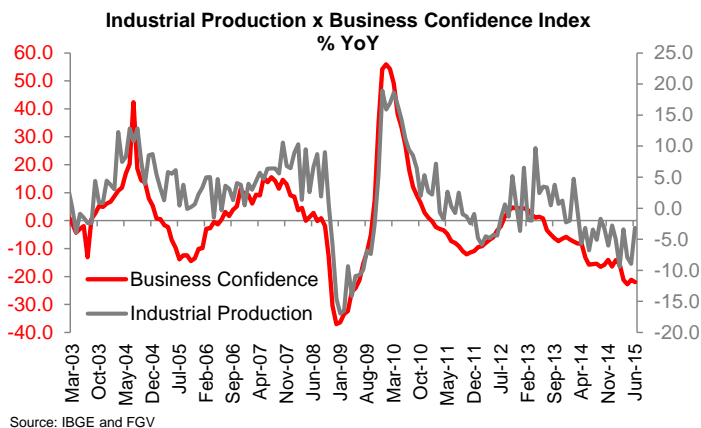
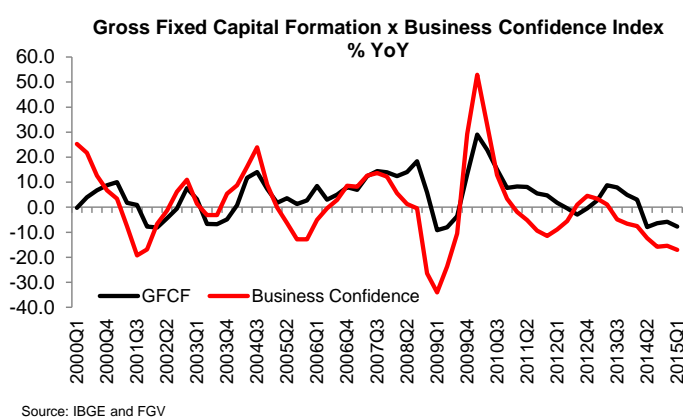


Fog on the road

The cloudy political environment and the weakness of the fiscal adjustment increased the uncertainties across the Brazilian economy in the last few weeks, all of which should tend to reinforce the postponement of investment and consumption decisions and lead to a deeper recession, in our view. Indeed, the downward revisions of primary surplus targets in 2015, 2016, and 2017 (announcement on July 22) triggered a sharp rise in the country risk premium, owing to doubts related to the ability and willingness of the Brazilian government to approve additional austerity measures in order to improve its primary balance results. Moreover, we think significant disagreements on the political front and poor governance have also created greater nervousness in the markets and led to a further worsening in economic outlook.



As we have noted, the recovery in confidence indicators is necessary to reverse the negative trend in economic activity. According to our estimates, the business confidence levels precede the dynamics of the industrial production and investments (Granger Causality Test)¹ – see Appendix. In turn, it seems to us that investor risk perceptions, market volatility, and even the dynamics of economic activity exert an impact on the confidence index.



How deep is the well?

We developed a Vector Autoregressive Model involving GDP growth, business confidence, and consumer confidence. As exogenous variables, we included the Brazil risk premium (5-year CDS), Global PMI Composite, World Trade Index, and U.S. Volatility Index (VIX)². The model outcome confirmed our expectation and showed that both the consumer and business confidence indicators affect GDP growth, but the latter exerts a stronger and more lasting effect. At the same time, the GDP

¹ Granger Causality Test is a statistical hypothesis test for determining whether one time series is useful in forecasting another.

² VAR specification with two selected lags – Schwarz Bayesian Criterion (BIC), considering the sample period from 2005Q03 to 2015Q01.



variation also exerts a positive impact on business confidence, although it is much more modest. Lastly, GDP growth posted no statistically significant effect on the consumer confidence dynamics.

Thus, we focused our analysis on which factor could trigger a reversal in the negative trend of business confidence. In our view, the inflection point of economic activity is closely related to the issue of consistent signals of the government's ability to persist and materialize the rebalancing of public finances, improve the transparency of its accounts and implement a reform agenda in order to restore the competitiveness of domestic companies. Therefore, the reduction of uncertainty emerges as a key factor.

For the sample period ranging from January 2004 to July 2015, we estimate CDS movements precede (“Granger-causes”) the business confidence movements, confirming that the country risk measure may provide relevant information about the turning point of economic activity.

Pairwise Granger Causality Tests

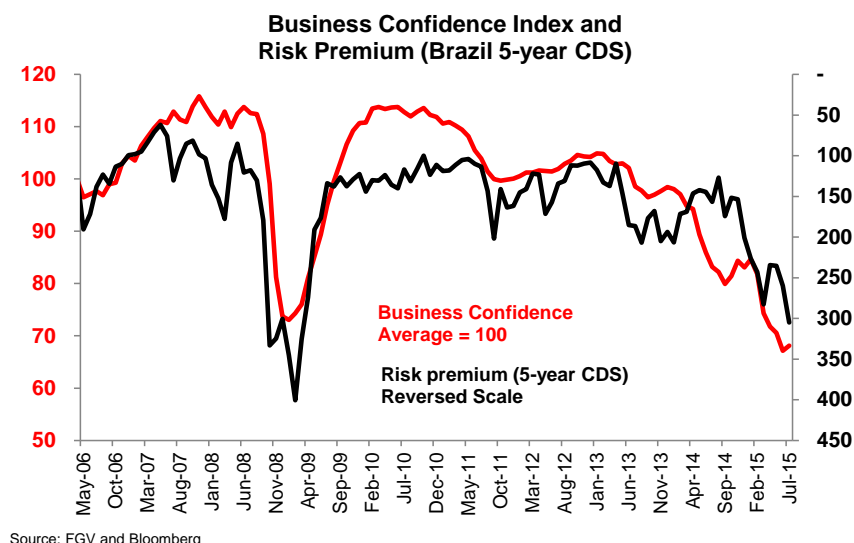
CDS: Credit Default Swap and CONF: Business Confidence Index

Sample – 2004M01 2015M07

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Null Hypothesis	Obs	F-Statistic	Prob.
log(CDS) does not Granger Cause log(CONF)	139	3.96087	0.0213
log(CONF) does not Granger Cause log(CDS)		0.88760	0.4141

Sources: Bloomberg and FGV.

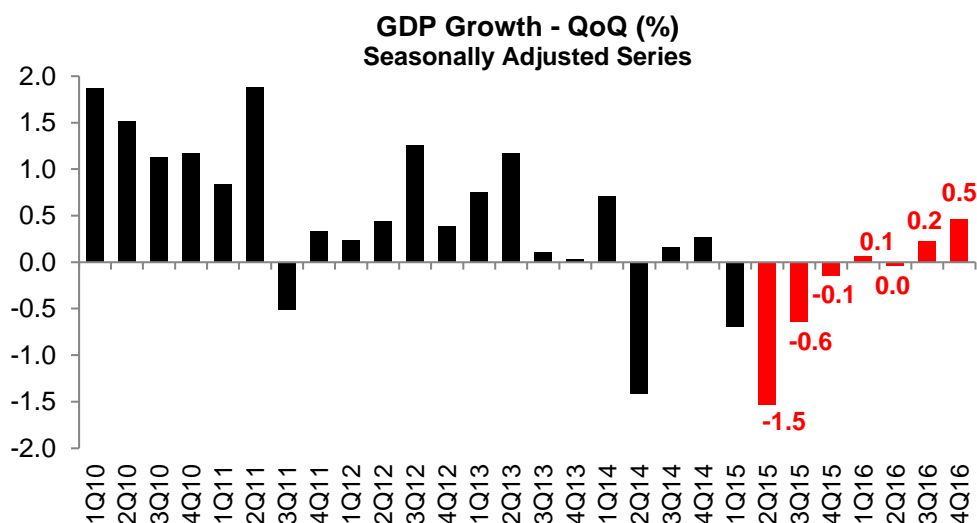


In this sense, it seems to us that the sharp rise in Brazil CDS in recent weeks, mostly driven by deteriorating prospects regarding the fiscal adjustment and by political turmoil, suggests a recrudescence in the recessionary outlook and a longer-than-expected time frame for any recovery.

But, despite our scenario that it will take more time than previously expected for the government to overcome difficulties related to achieving the primary surplus target in 2015 and 2016 (see our report *The Fiscal Maze (II) – Divergent*, August 13, 2015), we believe CDS will fall from the current exaggerated levels (see *Persistent Uncertainties*, August 21, 2015, and *How Much Is Too Much for the BRL and the Selic?*, July 30, 2015) through the beginning of next year.

With this, we now believe business confidence will gradually recover from late 2Q16 onward, driving economic activity to grow consistently only in 2H16.

Therefore, we revised downward our expectation for GDP growth this year to -2.3% from -1.9% (see *Persistent Uncertainties*, August 21, 2015). For 2016, we now expect a 0.5% decrease in GDP (previous: +0.1%).



Source: IBGE

Forecasts: Santander

Our expectation of a 0.5% drop in 2016 GDP corresponds to an average quarterly growth of +0.13% q/q next year. According to our estimates, the carryover for GDP next year is -0.8%.

In our view, the CDS behavior is not the only driver for the recovery of economic activity, but we believe it reflects factors that should play a major role, highlighting the effectiveness of the fiscal adjustment under way and, inherently, the political environment. As we have noted above, investments and industrial production seem to react strongly to the business confidence trajectory, and the magnitude of a potential economic recovery in 2016 would mainly affect the performance of these components.

Indeed, looking at the GDP breakdown, we do not see much room for a reversal in the downward trend in private consumption in upcoming quarters. The tighter credit market and a further deterioration in labor market conditions sustain our view of a decline in household consumption in 2016 – we forecast the unemployment rate reaching 9.2% at the end of 2016 (2015: 8.1% eop), seasonally adjusted, and the real aggregate wages decreasing around 2.5% next year (2015: nearly -4%). On the other hand, we think the improvement in net exports, boosted by the BRL's depreciation, will be important to prevent a more significant decrease in GDP next year. Thus, we forecast a positive contribution of 0.6 pp coming from the external sector in 2016.

GDP Breakdown (%)				
	2013	2014	2015 F	2016 F
GDP	2.7	0.1	-2.3	-0.5
Supply Side				
Agriculture and livestock	7.9	0.4	2.1	1.8
Industry	1.8	-1.2	-4.3	-1.4
Services	2.5	0.7	-1.7	-0.4
Demand Side				
Household Consumption	2.9	0.9	-2.4	-1.0
Government Expenditure	2.2	1.3	-2.0	0.4
Investments	6.1	-4.4	-9.3	-1.8
Exports	2.1	-1.1	3.4	4.1
Imports	7.6	-1.0	-6.8	-0.8

Source: IBGE

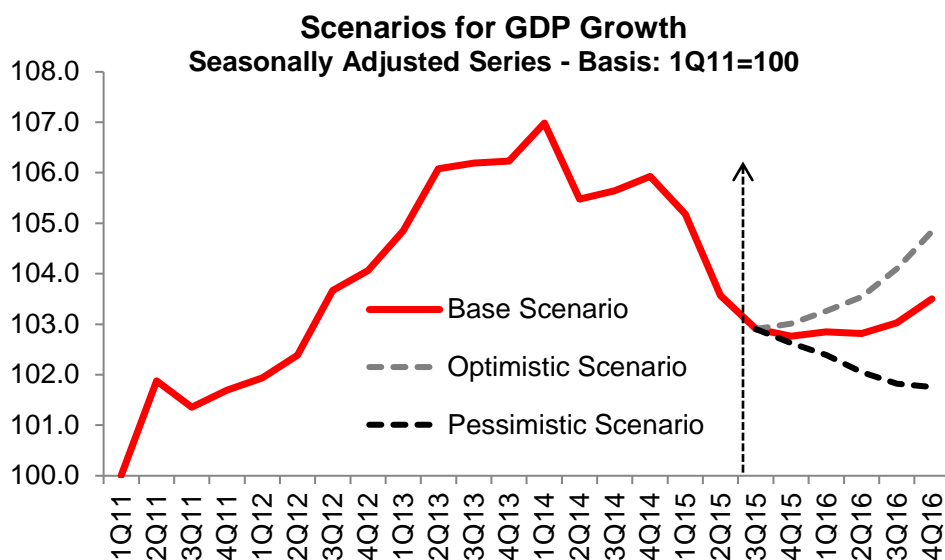
Forecasts: Santander



Alternative scenarios

Due to the high sensitivity of CDS dynamics to fiscal policy and other political issues, it is valid to present our view for alternative scenarios, based on our model that relates GDP growth to confidence levels – see the Appendix. (1) In the first scenario, considering a decline in CDS levels in the coming months and a more rapid resumption in business confidence by the end of this year, we see economic activity as stable in 4Q15 and increasing at the beginning of 2016. **This optimistic scenario contemplates slight growth (around +0.5%) next year, according to our estimates.** (2) In the second scenario, considering additional increases in risk perception, the confidence indicators would tend to remain at very low levels throughout 2016, accordingly leading to a deeper deterioration of the Brazilian economy. **This pessimistic scenario indicates a much sharper contraction in GDP (around -1.5%).**

Therefore, we reaffirm that a reduction in political instability and a decrease in uncertainties related to the fiscal adjustment seem to have great importance for any potential improvement in economic activity. We see these as necessary but not sufficient conditions for the Brazilian economy having better prospects in the upcoming years, especially due to the low potential growth.



Source: IBGE

Forecasts: Santander



Appendix

(I) Granger Causality Tests

Pairwise Granger Causality Tests

GFCF: Gross Fixed Capital Formation and CONF: Business Confidence Index

Sample – 1999Q3 2015Q1

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Null Hypothesis	Obs	F-Statistic	Prob.
log(CONF) does not Granger Cause dlog (GFCF)	63	5.34341	0.0074
log(GFCF) does not Granger Cause log(CONF)		0.97014	0.3851

Sources: IBGE and FGV.

Pairwise Granger Causality Tests

IP: Industrial Production and CONF: Business Confidence Index

Sample – 2002M4 2015M6

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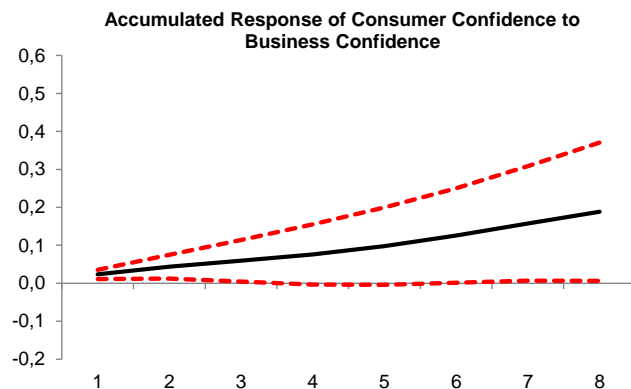
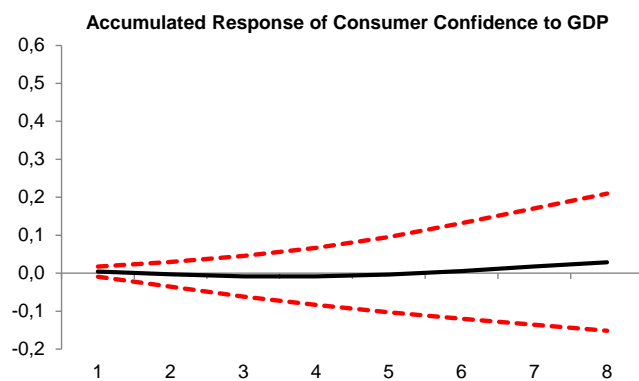
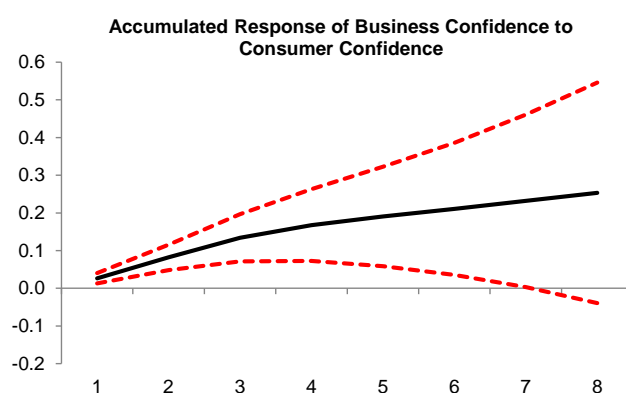
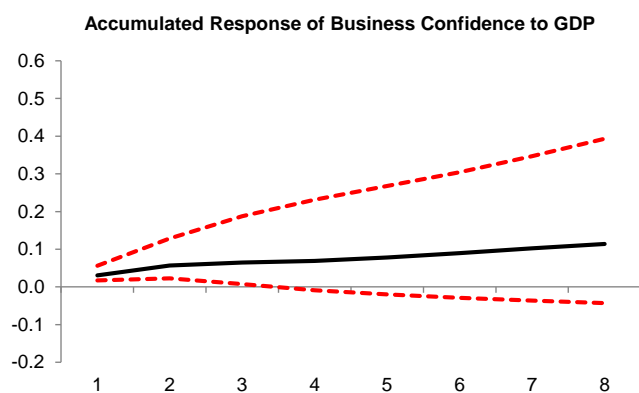
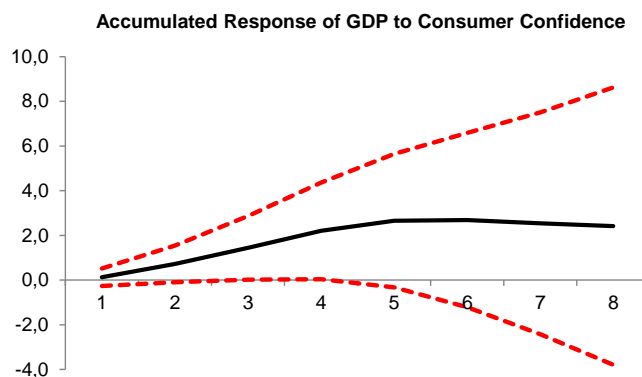
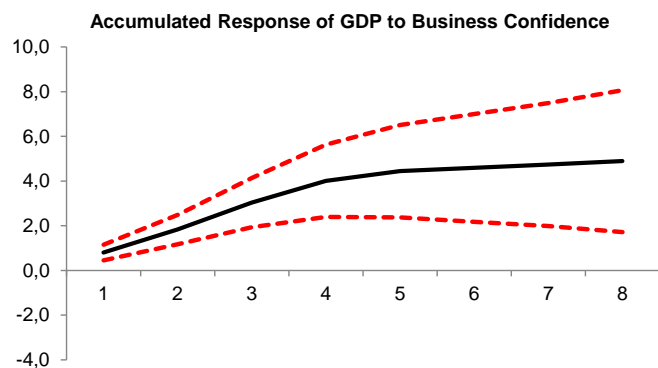
Null Hypothesis	Obs	F-Statistic	Prob.
log(CONF) does not Granger Cause dlog (IP)	159	23.0767	0.0000
log(IP) does not Granger Cause log(CONF)		0.52982	0.5898

Sources: IBGE and FGV.



(II) Vector Autoregressive Model – GDP Growth and Confidence Indexes

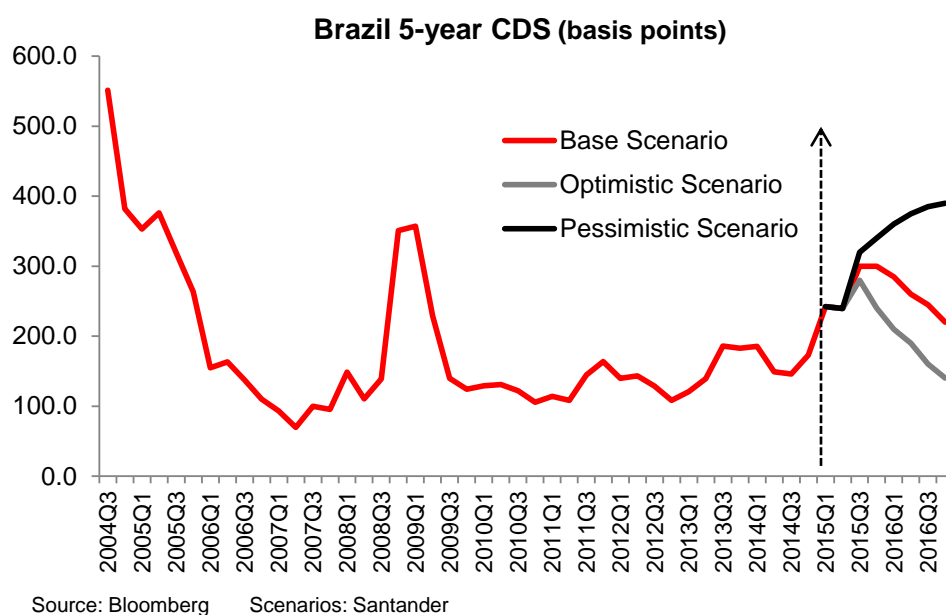
Accumulated Response to Generalized One Standard Deviation Innovations + or - 2 Standard Errors



Sources for all charts: IBGE, FGV, Markit, CPB Netherlands Bureau, Bloomberg. Estimates: Santander.



(III) Scenarios for Country Risk – Credit Default Swap





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