Santander

ECONOMICS February 27, 2019

Brazil – Economic Activity

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Is The Glass Half Empty or Half Full?

- **Slow motion…this was the pace of Brazil's GDP in 4Q18. We estimate that GDP remained flat last quarter, implying full-year growth of only 1.1% in 2018 (our previous expectation was 1.3%).**
- **We expect the economic recovery to gain momentum in 2019, with GDP performing better than in the last five years.**
- **However, we have also revised downwards our forecast for 2019 GDP growth (to 2.3% from 3%), mainly due to the: (i) lower statistical carryover effect implied by 2018 GDP growth; (ii) more challenging international scenario, particularly the slowdown in advanced economies (e.g., eurozone and China); (iii) Argentine economic recession, which heavily affects Brazilian industry; and (iv) less favorable dynamics in mining and agricultural activities.**
- **Looking ahead to 2020, we continue to expect Brazil's GDP to expand by 3%. We believe that the pension reform approval will boost business and consumer confidence, leading domestic demand to a faster pace of recovery.**

GDP Breakdown (% Annual Growth)

Components	2015	2016	2017	2018F	2019F	2020F
Total GDP	**-3.5**	**-3.5**	**1.0**	**1.1**	**2.3**	**3.0**
Agriculture & Livestock	3.3	-4.3	13.0	1.3	2.0	2.5
Industry	-5.8	-4.0	0.0	0.4	1.6	3.3
Services	-2.7	-2.6	0.3	1.4	2.4	2.9
Household Consumption	-3.2	-4.3	1.0	1.8	2.2	3.0
Government Consumption	-1.4	-0.1	-0.6	0.1	-0.2	0.6
Investments	-13.9	-10.3	-1.8	4.1	4.5	7.0
Exports	6.8	1.9	5.2	4.4	2.7	3.2
Imports (-)	-14.2	-10.2	5.0	8.6	3.5	3.7

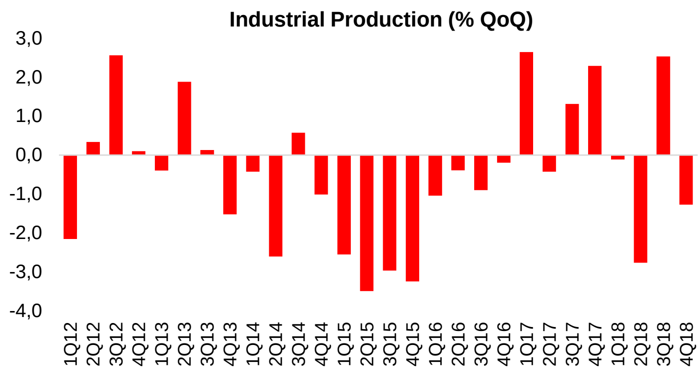
Sources: IBGE and Santander estimates

Disappointing 4Q GDP

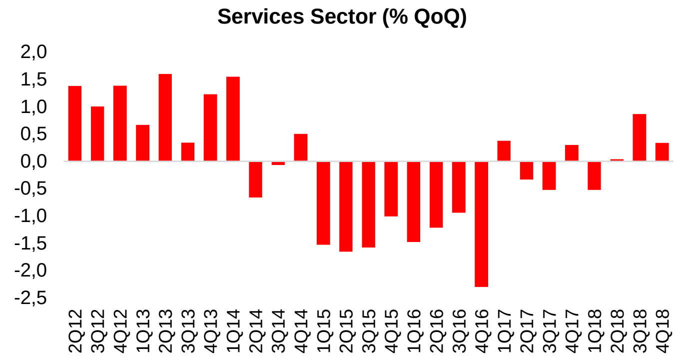
Slow motion….this was the pace of Brazil's GDP in 4Q18, confirming frustrating results for domestic economic activity last year. It is worth noting that market expectations pointed to robust expansion at the beginning of 2018, but a set of widely discussed factors (e.g., the truckers' strike, worsening international financial conditions, political uncertainties, among others) have drastically reduced the speed of economic growth.

We had expected GDP to gain momentum in 4Q, especially after October's general elections. Despite some increase in confidence indicators (mainly for consumers), GDP stagnated. Looking at the sectoral breakdown, Brazilian industry contracted 1.3% QoQ last quarter, mostly due to the plunge in automotive output (-8.1%) — lower exports to Argentina contributed significantly to this performance. Regarding the retail sector, the success of Black Friday promotional sales in November, combined with slightly better Christmas sales in December, brought some relief, but not enough to accelerate domestic demand. In short, economic activity remained lethargic in 4Q, further reducing projections for Brazil's GDP in 2018.

We estimate that GDP remained flat in 4Q (0% QoQ; 1.2% YoY), implying full-year growth of only 1.1% in 2018 (our previous expectation was 1.3%). Results for 4Q18 will be published tomorrow (February 28).



Source: IBGE



Source: IBGE

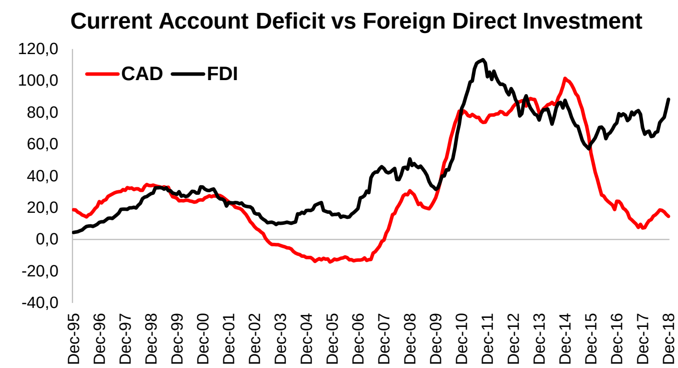
GDP Breakdown (%)					
	% YoY		% QoQ		2018E
Components	3Q18	4Q18E	3Q18	4Q18E	
Total GDP	**1.3**	**1.2**	**0.8**	**0.0**	**1.1**
Agriculture & Livestock	2.5	5.3	0.7	1.9	1.3
Industry	0.8	-1.0	0.4	-1.1	0.4
Services	1.2	1.5	0.5	0.5	1.4
Household Consumption	1.4	1.0	0.6	0.1	1.8
Government Consumption	0.3	-0.3	0.3	0.0	0.1
Investments	7.8	3.2	6.6	-2.5	4.1
Exports	2.6	12.4	6.7	3.7	4.4
Imports (-)	13.5	6.5	10.2	-6.2	8.6

Sources: IBGE and Santander estimates

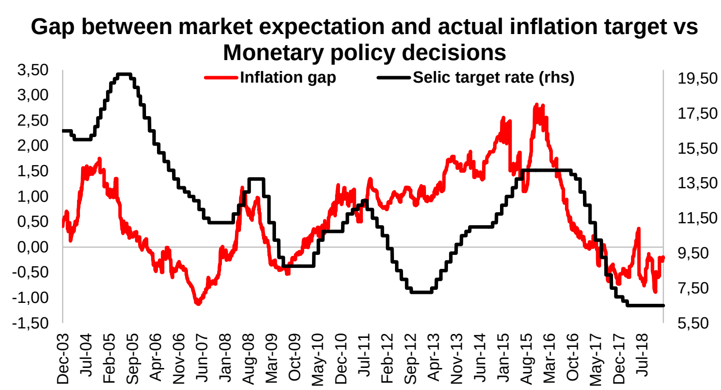
What About 2019?

(Half Full) Stronger Growth…

While acknowledging 2018's frustrating results, we have emphasized that Brazil has good macro fundamentals, such as: controlled inflation, low interest rates and solid external accounts. While true that there is a long way to go regarding the rebalancing of public finances, we have been increasingly confident that this issue will be addressed. Accordingly, **we expect Brazilian economic recovery to gain momentum in 2019, with GDP performing better than in the last five years.**



Source: Banco Central do Brasil.



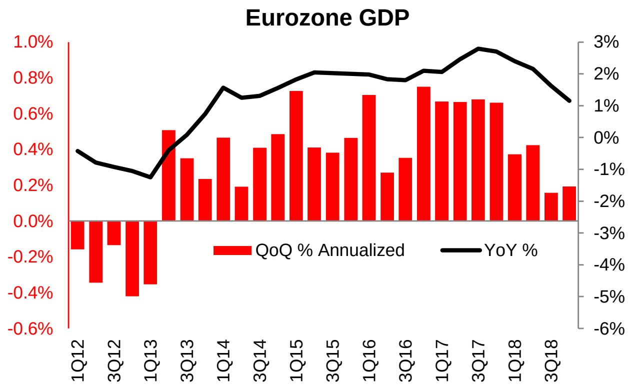
Source: Banco Central do Brasil,

(Half Empty) … But Not That Much

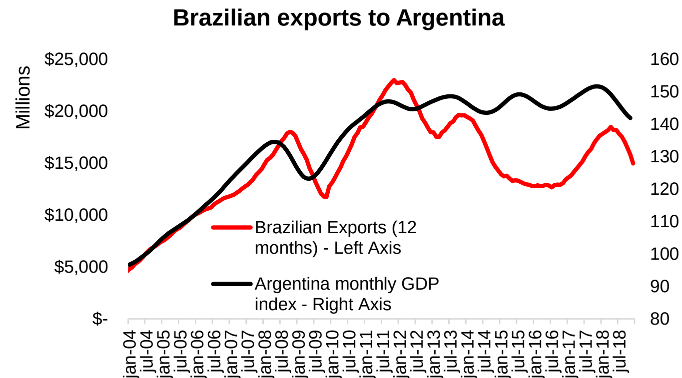
However, **other factors have led us to revise our 2019 GDP forecast to 2.3% from 3%.** Our first (and most obvious) reason is the **lower carryover statistical effect** implied by 2018 GDP growth (only +0.4 pp, down from +0.6 pp as previously expected). Second, we highlight the **challenging international scenario.** As we discussed in a recently published report see *Substantial Challenges and Risks in the Global Outlook: How Do They Affect Brazil?, January 29, 2019*), the balance of risks for the global economy has worsened. In our view, global economic growth seems to have a clear deceleration trend this year (mainly due to the eurozone and China), which could affect Brazilian economic growth in three main ways, by: (i) a weakening currency would increase the prices of imported goods, consequently, affecting investment; (ii) slowing global trade would reduce Brazilian exports, leading to a smaller contribution from the external sector to total GDP; and (iii) increasing global risk aversion could spur deteriorating international financial conditions.

In the aforementioned report, we painted a pessimistic scenario marked by a significant reduction in global economic growth that could lead to a 2-pp loss for Brazil's GDP over the next two years. Although our outlook for the global economy is not as pessimistic (we expect a moderate slowdown), we admit that our view on the international environment was more favorable a few months ago. Thus, **the "international economy component" triggered a reduction of 0.3 pp in our previous expectation for 2019 GDP growth.**

Still on the international scene, the Argentine recession also plays an important role. As a major trade partner in Latin America, Argentina's fragile economic situation will significantly affect Brazilian exports. According to another report recently released by our team (see *Economic Derby: Rivals or Teammates?*, February 19, 2019), the automotive sector will probably be the most affected, dragging down Brazilian industrial production. **We estimate that the worsening Argentine economy could reduce Brazil's manufacturing industry GDP by 0.3 pp in 2019 (and total GDP by around 0.05 pp).**

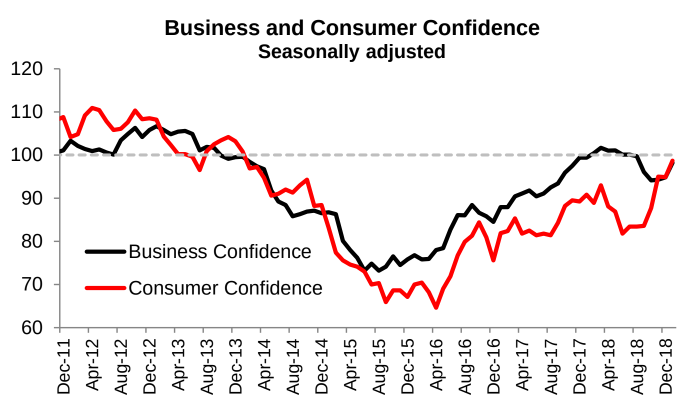


Source: Eurostat

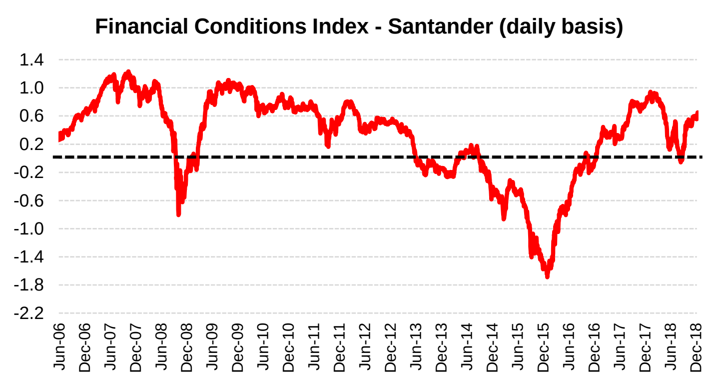


Furthermore, despite having mining and agricultural weighing relatively small amounts in the overall composition of Brazil's GDP, we highlight that **their performance output should be weaker than previously anticipated.** With respect to mining, the Brumadinho dam collapse is the main culprit behind our downward revision for mineral extraction activity this year (due to direct effects in the region severely hit by the tragedy, combined with the indirect effects from interrupted extraction in other locations). With regard to the agricultural sector, 2019 forecast for grain crops (mainly soybeans) have been revised downwards in recently, although they continue to point to expansion compared to last season. Therefore, **these two sectors' less favorable dynamics were also considered in revising our 2019 GDP growth projections (we calculate a joint contribution of around -0.15 pp).**

In summation, we now expect Brazil's GDP to expand 2.3% in 2019 below the previous projection of 3%. Looking ahead to 2020, we, nevertheless, maintain our expectation of 3% growth. In our view, pension reform approval should boost business and consumer confidence, unlocking investments and consumption (for more information, please see Santander's report *It's Show Time: The Battle for Social Security Reform*, February 20, 2019). Thus, although we expect only a modest increase in 1H18, we reiterate our view that GDP will likely be growing close to 3% YoY at year end, thereby creating room for a brighter performance next year.



Source: FGV



Source: Santander Estimates

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