ECONOMICS April 1, 2019

Brazil: Credit Report

Will Credit Be Enough to Revive Consumption?

Laiz Carvalho*
laiz.carvalho@santander.com.br
5511-3553-0933

- **With economic activity data disappointing market expectations so far this year, the main question is which component of GDP will bring the return of the country's growth.**
- **Given the conditions of industrial activity, the level of interest rates, and inflation behavior, we believe that the main driving force behind growth will be consumption.**
- **We focus on the two main drivers of consumer spending: increasing household incomes and expanding access to credit. Visibility on the first is still poor due to the slow recovery in the labor market (we expect the unemployment rate for 2019 to remain high, at 11.2%), but the second already shows signs of growth and acceleration, especially after the uncertainty experienced in 2018.**
- **Within the credit concession, we believe the highlight will be real estate, which has better conditions for expansion in the short and medium term.**
- **Therefore, we think it will be the time for the building sector to thrive.**

Figure 1. Confidence Indicators

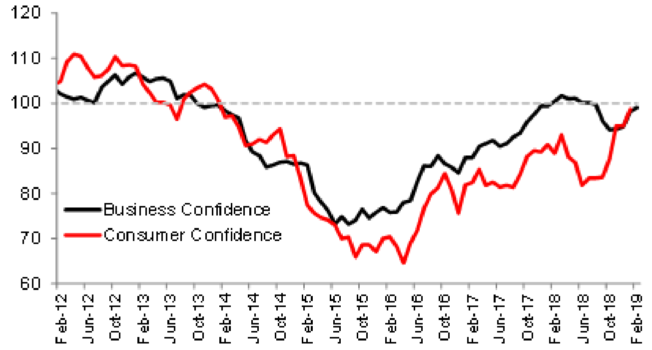
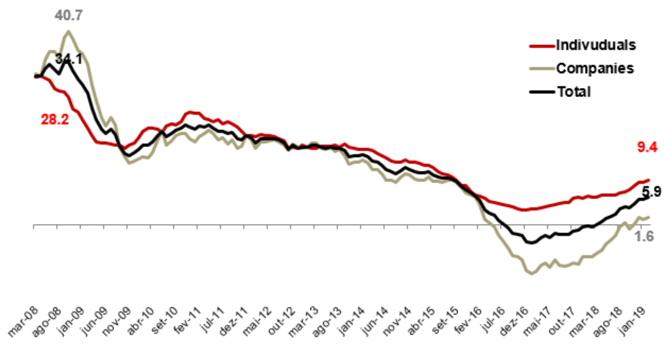


Figure 2. New Loans MoM (%)



Sources: IBGE, Brazilian Central Bank, and Santander estimates.

Introduction

The long-awaited revival of Brazilian economic activity has not yet come. Analyzing the macroeconomic variables, inflationary stability, and the low level of interest rates, the question of the moment is: **"Why not?"**

Looking at GDP from the demand side, we have the well-known formula that appears in all the introduction to economics and macroeconomics textbooks: a country's GDP is measured by the sum of its consumption, government spending, and investments and the differential between exports and imports (being positive if a country exports more goods than it imports).

Government spending needs to decrease, in our view, via the needed fiscal adjustment. Thus, it is not from this component that GDP growth will come. Brazil is experiencing low growth in industrial production, coupled with the crisis in Argentina and uncertainty in developed economies in the rest of the world. Therefore, the trade balance will not be sufficiently substantial to help the economy recover, and foreign investors are concerned about the external and internal risks of investing in Brazil.

Hence, the main impulse for the resumption of economic activity growth should come from an increase of consumption by households. But how to stimulate this consumption?

As can be seen in Figure 1, household and business confidence is returning to levels of neutrality (close to 100 points), which shows a certain optimistic but cautious view of the future in the short term. **Corroborating this data, the levels of credit relative to GDP are also increasing and returning to the pre-crisis levels last seen in 2014,** especially in the non-earmarked sector – that is, credit that is not necessarily tied to any government agency or subsidy (consequently leading to a decrease in the total number of the earmarked credit concession).

Thus, our thesis is that this revival of economic activity will come via consumption by individuals, which depends mainly on family income and interest rates. Since interst rates (second component) are historically low (Selic at 6.5%), **increased consumption will depend on income levels and the economy's ability to access the credit market.**

In waiting mode

We expect the increase in income to come from a strengthening labor market and the consequent increase in wages. Figure 3 shows still **high rates of unemployment are expected for 2019, with real wages slightly higher than those of 2018 but still below the economic capacity of Brazil.** This is mainly due to the still slow recovery in economic activity. With income still highly dependent on the labor market, we then turn to the credit market as the major driver of consumption in the short term.

Figure 3. Average Unemployment Rate (%) and Aggregate Wages(% y/y)

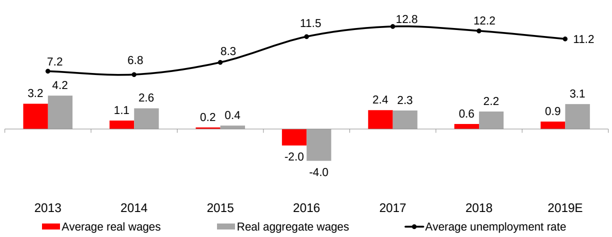
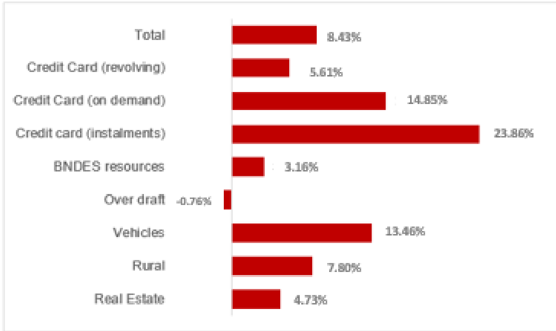


Figure 4. Growth in Loans to Individuals by Modality (Jan-2019/Jan-2018)



Sources: IBGE, Brazilian Central Bank and Santander estimates.

Noting the growth in lending to households in the last 12 months (with data up to January 2019), we have seen expansion on almost all levels except for the overdraft credit sector. This already indicates a greater appetite of families for credit than what has been observed in recent years.

Another good sign of a recovery in credit appetite is the change in household debt over the past 10 years. Figure 6 shows that in the boom years of the Brazilian economy (the first decade of the 2000s), household debt was lower (about 30% of average income), with a small portion being used to pay real estate debt. That is, the profile of Brazilians' debt in this period was basically for consumption that was not tied to the real estate market. However, when we observe the passage of the years and, especially the most acute period of the crisis in the middle of 2015 and 2016, household debt increases to almost half of families' income, but with a different characteristic. **The level of debt without the real estate portion remains the same, but the proportion of debt allocated real estate has risen sharply and remains high, even though overall debt is lower than during the crisis years.**

We see a light at the end of the tunnel, which is real estate credit and the building sector.

Figure 5. Household Consumption GDP x Broad Retail Sales (% YoY)

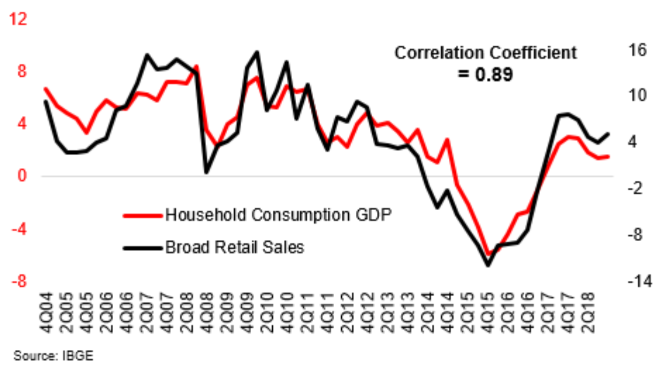
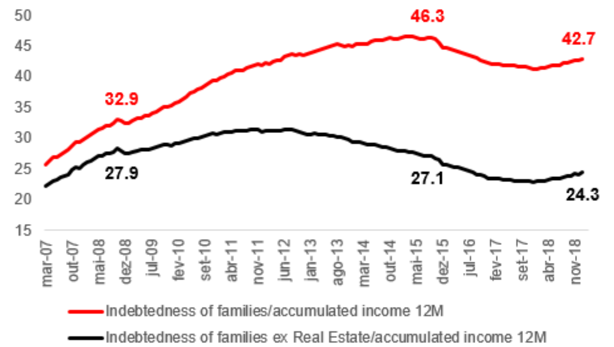


Figure 6. Household Indebtedness (% annual income)



Sources: IBGE and Brazilian Central Bank

Is it time to spend?

The real estate sector is one key element of consumption growth, in our view. We saw a change in the sector's dynamics in late 2018 owing to a change in the banking system's interest rate policy. The granting of subsidized real estate credit has higher interest rates for the market segment seeking financing for higher value properties (valued at up to R$1.5 million) and/or with higher monthly income. These interest rates rose from 8.76% to 9.01% per year (previously, rates were between 7.85% and 9.01% per year), which is in line with the data in Figure 7, which shows a drop in interest rates for this sector since 2016, with a recent high at the end of last year due to the change in the banking system's interest rate policy.

Figure 7. Interest Rate – Real Estate

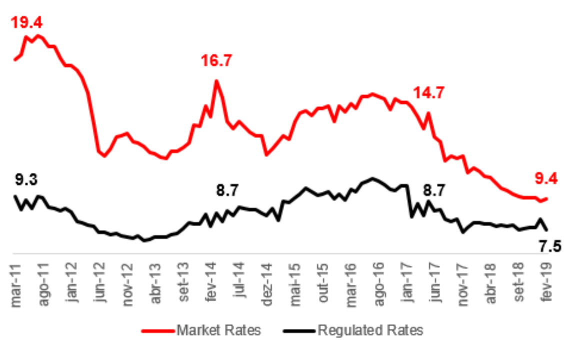
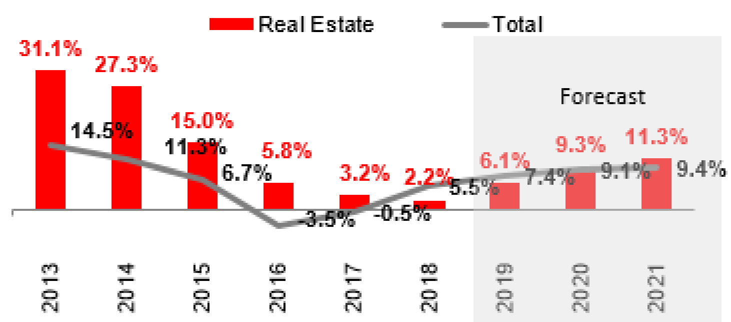


Figure 8. Credit Growth Forecast for the Next 3 Years

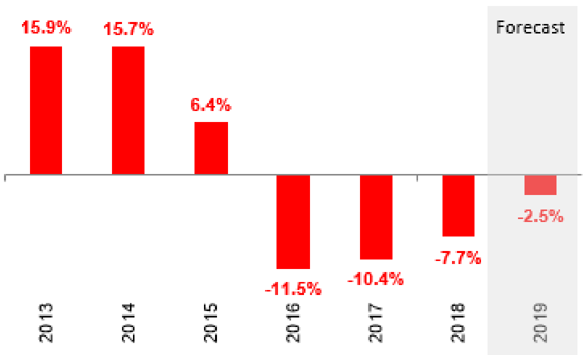


Sources: Brazilian Central Bank and Santander estimates.

We expect growth of the loan portfolio as a whole, especially in the real estate sector. For this reason, we believe that the economy will grow consistently in the coming quarters.

Figure 9 shows a significant decrease in BNDES loans in the real estate sector. **Thus, we believe that most of the credit supply will come from private banks.** We expect in the short term a change in the dynamics of loans, with a larger share of the market being represented by the non-earmarked credit, mainly from private banks.

Figure 9. BNDES Loan Growth



Source: BCB. Forecast:Santander

Figure 10. Credit Forecast

	2018	2019F	2020F
Non earmarked credit	11.2%	10.8%	10.8%
Individuals	11.3%	11.4%	11.4%
Corporate	11.2%	10.1%	10.2%
Earmarked credit	-0.6%	3.4%	6.9%
Private banks	12.4%	13.0%	12.5%
Public Banks	-0.5%	2.1%	5.5%
Total Credit	5.5%	7.4%	9.1%

Final Considerations

Unlike last year, with the beginning of the economic recovery, we anticipate loan growth in practically all credit modalities. That is, the bases for a recovery in consumption are supported by the simulations presented previously.

The deceleration in consumption observed in 2018 has been reversed, and confidence levels have been returning to neutral (100 points) for both companies and households. We have already seen an expansion of household consumption, mainly in credit data and, specifically, in real estate credit.

This does not mean, however, that all the drivers of a resumption in economic growth boil down to a recovery in consumption. Based on the assumption that the pension reform proposal will be approved this year, consumer confidence and credit conditions should improve, in our view, accelerating an economic recovery.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.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
Diana Ayala	Economist – Colombia, Peru	diana.ayala@santander.us	212-407-0979
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537

Fixed Income Research

Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
David Franco*	Macro, Rates & FX Strategy – Latin America	david.franco@santanderCIB.co.uk	44-207-756-6633
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
Nicolas Schild*	Head, Chile	nschild@santander.cl	5622-336-3361
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Cecilia Jimenez*	Head, Mexico	mcjimenez@santander.com.mx	5255-5269-2228

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: Laiz Carvalho*.

*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.

Santander