Santander

BRAZIL ECONOMICS

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ECONOMIC ACTIVITY

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Standby Mode

- **Considering the direct and indirect effects of the truckers' strike, we revised our projection for 2018 GDP growth in late May. However, even though most of the effects have dissipated, Brazilian economic activity still has been showing significant difficulty in gaining steam.**
- **Thus, other relevant factors behind the disappointment with 2018 activity coincident indicators are discussed in this report.**
- **First, we have seen a significant deterioration of the balance of risks in the international economy recently. The rise of protectionism in the world (especially between United States and China) and recent crises in Turkey and Argentina are some of the elements that explain the higher global risk aversion and lower appetite for emerging countries' assets.**
- **Looking at the domestic outlook, uncertainty about the October elections and execution of fiscal consolidation measures in the coming years remains extremely high, explaining a relevant part of the worsening financial conditions in Brazil.**
- **In line with the aforementioned factors, we have seen a decline in business and consumer confidence, which affects consumption and investment decisions and, consequently, economic growth. In other words, many economic participants (entrepreneurs, investors, consumers) seem to be in "standby mode" after international and local factors increased their risk perception.**
- **Therefore, we are reducing our 2018 GDP growth projection to 1.5% from 2%.**
- **On the other hand, we are maintaining our forecast of a 3.2% expansion in 2019 GDP, based on a government committed to fiscal adjustments – that is, a government that understands the need for reforms and the importance of the so called "macroeconomic tripod". We highlight that Brazil has strong macro fundamentals, such as controlled inflation and balanced external accounts. Hence, after the dissipation of uncertainty toward the end of the year, we estimate a high potential for a faster recovery in economic activity.**

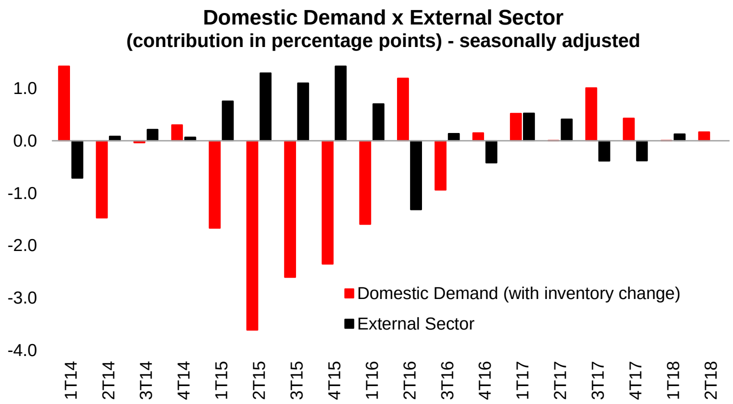
GDP Breakdown (%)

Components	2015	2016	2017	2018E	2019E
Total GDP	**-3.5**	**-3.5**	**1.0**	**1.5**	**3.2**
Agriculture & Livestock	3.3	-4.3	13.0	0.4	2.5
Industry	-5.8	-4.0	0.0	1.7	3.6
Services	-2.7	-2.6	0.3	1.4	3.1
Household Consumption	-3.2	-4.3	1.0	2.3	3.0
Government Consumption	-1.4	-0.1	-0.6	-0.2	-0.3
Investments	-13.9	-10.3	-1.8	3.5	8.0
Exports	6.8	1.9	5.2	4.0	3.7
Imports (-)	-14.2	-10.2	5.0	5.4	4.2

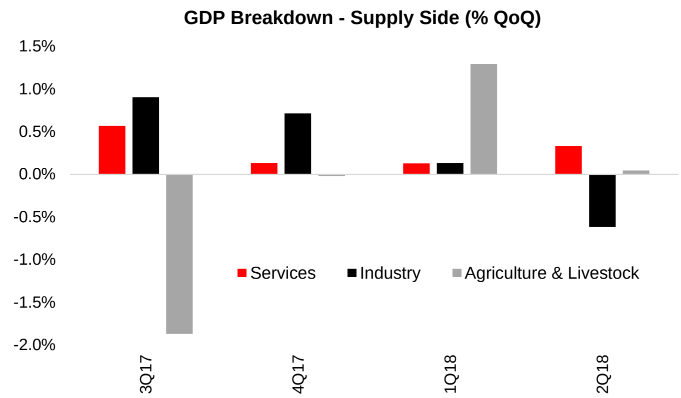
Sources: IBGE and Santander estimates

Truckers’ Strike and 2Q GDP

The modest growth of GDP in 2Q18 (0.2% QoQ; 1.0% YoY) was exactly in line with our expectation just after the truckers’ strike occurred in late May. Regarding the main GDP components, the decline in industry and investment, as well as the relative stability of household consumption, were the key signals of the weak economic growth in the recent period.



Sources: IBGE and Santander



Sources: IBGE and Santander

As we highlighted in previous reports (e.g., see *Truck Strike: A Preliminary Assessment*, May 29, 2018), **the trucker strike significantly impacted local economic activity in 2Q18**, owing to the lack of supply and production/sales stoppage in many segments of the economy. **However, it is worth noting that other factors also explain the economic slowdown in the short term.** In fact, after most of the strike effects had dissipated, activity indicators still show significant difficulty in gaining steam. Hence, we discuss in this report the main elements behind the low dynamism of the Brazilian economy throughout 2018, and we outline the prospects for the coming months.

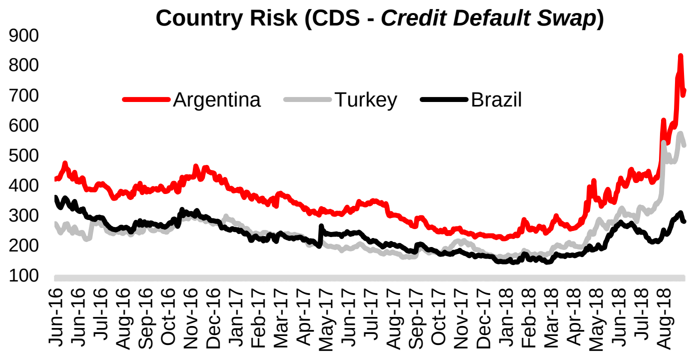
The “New World” and Domestic Uncertainties: Wavering Confidence

The international environment has changed considerably recently. The acceleration of U.S. economic growth has intensified the process of interest rate normalization, which has been strengthening the dollar versus other currencies, especially those from emerging markets. Furthermore, international trade has been particularly stressed, due to the rise of the protectionism tone mainly in the U.S. and Chinese economies, feeding doubts about the sustainability of global trade and commodity prices. Lastly, recent crises in Argentina and Turkey have also raised the levels of volatility and risk aversion in global financial markets.

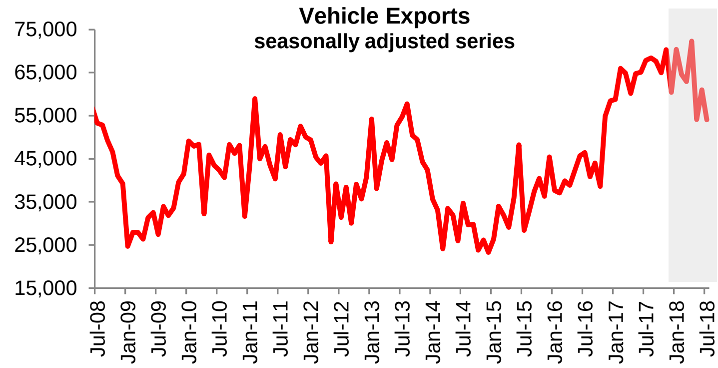
That is, **recent events in the international scene have been pressuring emerging markets, reducing the appetite for their assets, which also affects the Brazilian economic recovery, especially through the investment channel.** The negative effects are not more significant because of the solid external accounts in Brazil, marked by a high volume of international reserves and direct investments, as well as low current account and debt deficits.

In addition to the impact via the financial channel, we highlight that **the weakening of the Argentinean economy also affects the Brazilian economy through trade, as the destination of a significant portion of Brazil’s manufacturing exports is its Latin American neighbor.** It is worth noting that Argentina is the destination for around 80% of the automotive sector’s external sales, and this industry directly accounts for more than 10% of Brazilian industrial production. Although most of the sector's slowdown is explained by internal factors, the negative impact coming from Argentina is far from negligible.

Looking at the domestic scene, Brazil faces a lot of uncertainties regarding the electoral outlook. The doubts about what will be the configuration of the executive and legislative powers, the fiscal commitment of the next government and the ability to approve reforms in the coming years have led to high volatility in markets, explaining much of the deterioration in financial conditions in Brazil.



Source: Bloomberg

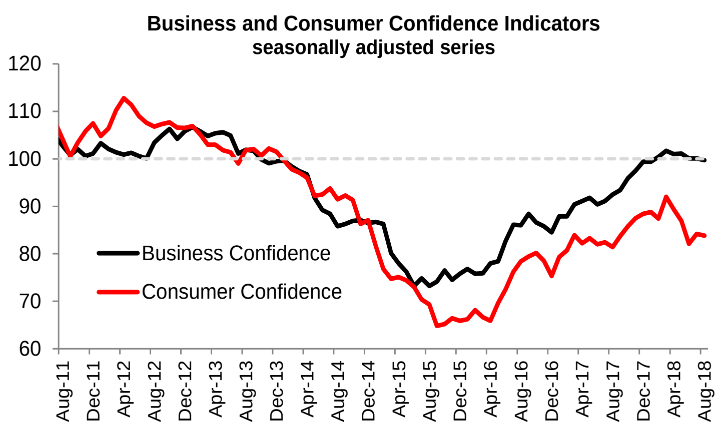


Source: ANFAVEA

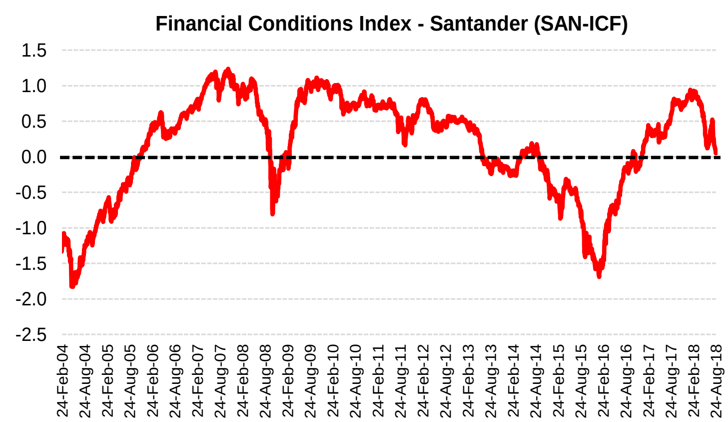
Along those lines, Santander recently introduced a Financial Condition Index (SAN-ICF) which aims at synthesizing in a single indicator the evolution of the main market variables that may influence the financial conditions facing the various economic agents (please see, *Worse Financial Conditions at the Margin Reinforce the Likelihood of Selic Remaining "Low for Long*", August 30, 2018).

The weak performance of SAN-ICF reinforces our assessment that GDP has lost momentum in the short term. In fact, recent data suggest that, even with the interest rate remaining at low historical levels, financial conditions have not been (marginally and effectively) stimulative.

In line with the aforementioned factors, we have seen a decline in business and consumer confidence, which affects consumption and investment decisions and, consequently, economic growth. **In other words, many economic participants (entrepreneurs, investor, consumers) seem to be in "standby mode" after international and local factors increased their risk perception. Again, it seems to be a lack of confidence issue.**



Source: FGV

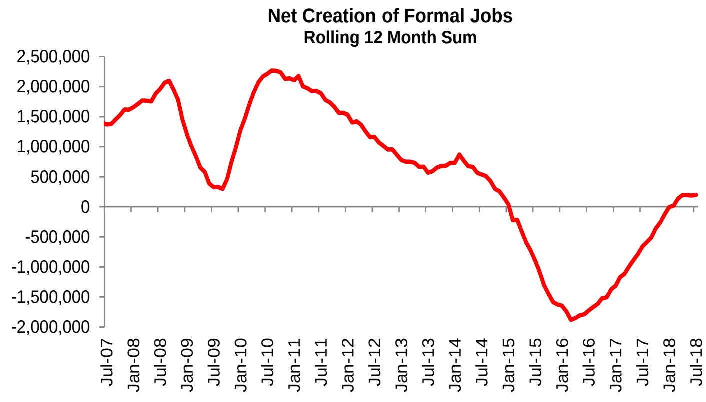


Source: Santander estimates

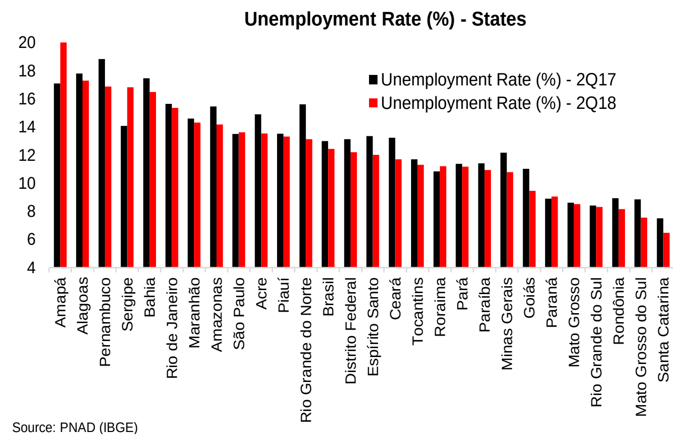
As consequence of the low confidence, the labor market has shown a much weaker performance than previously expected. For example, the Brazilian unemployment rate reached 12.3% in the quarter ending in July, only 0.5pp lower than the level observed in the same period of 2017. Such poor performance is due, to a great extent, to the low creation of formal jobs: according to the Ministry of Labor and Employment (MTE), there was a net creation of nearly 200 thousand formal occupations in the last 12 months through July, following a net destruction of more than 3 million jobs during the recession (between mid-2014 and late 2016).

Furthermore, is important to note the significant regional discrepancies regarding labor market conditions. For example, the average unemployment rate in the Northeast region reached 14.8% in 2Q18, while the average rate in South region was 8.2% in the same period.

That fragile performance of the labor market (only a slight improvement in labor and income levels) has prevented stronger growth in household consumption. The expansion of this component, which accounts for more than 60% of total GDP, slowed from 1.2% QoQ between 2Q17 and 3Q17 to 0.2% QoQ in the period between 4Q17 and 2Q18 (on average).



Source: Ministry of Employment and Labor (MTE)



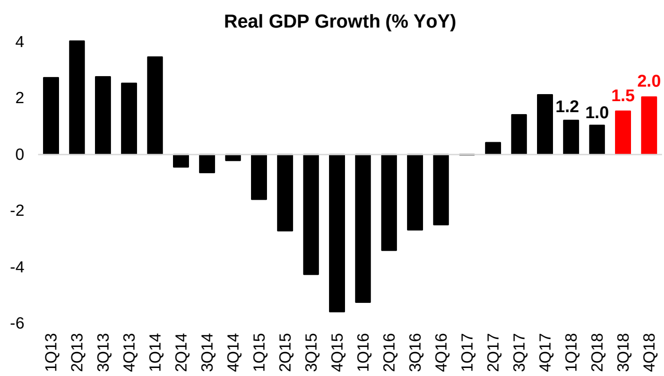
Source: PNAD (IBGE)

Acknowledge the Turbulences, But Don't Forget the Good Macro Fundamentals

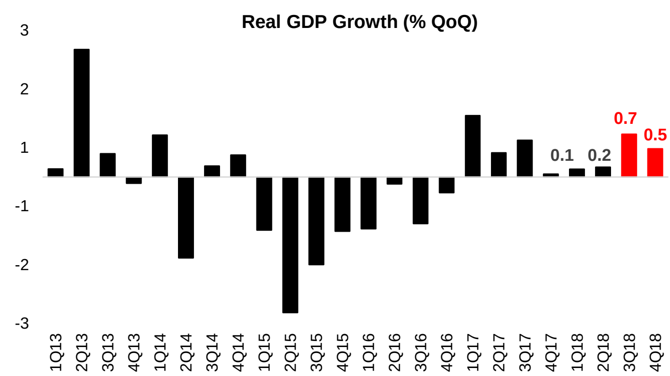
Despite the unfavorable behavior of financial conditions and confidence indicators in the past few months, important macroeconomic fundamentals remain solid in Brazil. In addition to the aforementioned balanced external accounts, inflation remains well controlled – we expect 2018 CPI to grow 3.9%, below the inflation target of 4.5% – and new credit concessions are expanding consistently (due to the cumulative and lagged effects of monetary policy).

Moreover, some specific factors should contribute to the expansion in domestic activity through the second half of 2018, namely: (i) release of PIS/PASEP resources for individuals less than 60 years old, which should add 0.1pp to GDP by the end of the year, according to our estimates; and (ii) stronger growth of the extraction industry, especially due to higher oil production.

Based on the factors presented above, we are reducing our forecast for 2018 GDP growth to 1.5% from 2.0%. For 2019, nevertheless, we are maintaining our forecast for a 3.2% expansion, based on a government committed to fiscal adjustments – that is, a government with a reformist agenda and aligned with the so-called "macroeconomic tripod" (floating exchange rate, inflation target and fiscal responsibility). Hence, after the dissipation of uncertainties toward the end of the year, we see strong potential for a faster recovery in economic activity.



Sources: IBGE and Santander



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