Santander

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Brazil — GDP Growth Revision

Maintaining the Route but Adjusting the Speed:

A Gradual Economic Recovery

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- **The most recent releases of economic activity indicators have brought discouraging results, in our view. Reflecting the poor performance of the main productive sectors, in 3Q16 Brazil GDP posted its seventh consecutive contraction, making the current recession the longest and deepest of the historical data series.**
- **In addition to the disappointing 3Q figures, the coincident indicators of 4Q16 released so far also showed a contraction, pointing to shrinkage of domestic activity in the period, albeit at a less intense pace. We now expect the GDP variation to return to positive territory only in 1Q17, and, therefore, we are revising downward our forecast for real GDP growth in 2016, to -3.5% from -3.3%.**
- **The downward surprises brought by the economic activity indicators over 2H16 imply a notably negative carryover effect for GDP growth in 2017: we now calculate -0.7 pp, considerably below our previous estimate of only -0.1 pp.**
- **Furthermore, it is worth noting the rising uncertainties about the global economy's dynamics and further political turmoil on the domestic front in the recent period. Evidently, these factors increase risk perception and markets' volatility, which makes the expected resurgence of investments more challenging, in our view. And, looking at the other GDP components, we do not see significant impulses for economic growth; we highlight the poor performance of household consumption, which will likely continue to be dampened by the weakness in the labor market and credit concessions.**
- **Nevertheless, despite the still highly challenging environment for the Brazilian economy, we cannot disregard the improvement of important economic conditions: (i) domestic inflation has been falling steadily, and, even considering growing uncertainties about the pace of monetary easing, there is a consensus that there is room for interest rates to decline throughout next year; (ii) we see progress in the fiscal adjustment agenda, which we believe should help business confidence continue its upward trend next year and play a major role in the recovery of Brazilian industry and investments, albeit at a moderate pace; (iii) there is a continued reduction of industrial inventories; and (iv) we see a notably positive outlook for agribusiness.**
- **All in all, we reiterate our expectation that Brazil GDP will resume growth in 2017. Nevertheless, combining the latest round of activity variables (and their negative statistical effect) with recent turmoil in the international economic and political environment, we now forecast that GDP will grow 0.7% next year, significantly below our previous expectation of +2.0%. In other words, we think the Brazilian economy should return to positive territory in 2017, but this process will tend to be slow and gradual (a typical "U-shaped recovery").**

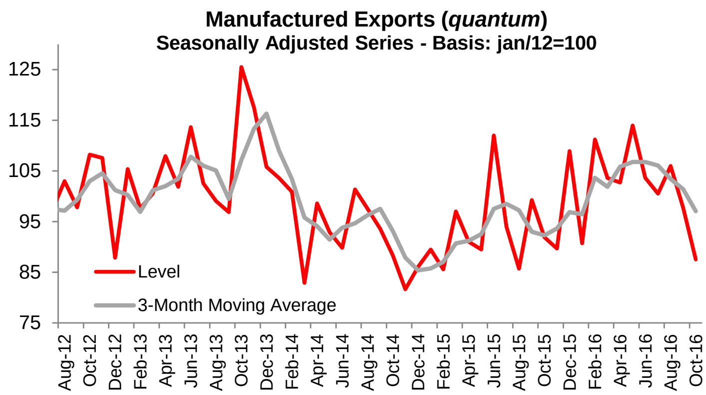
GDP Breakdown (%)

	2014	2015	2016 F	2017 F	2018 F
Total GDP	**0.5**	**-3.8**	**-3.5**	**0.7**	**3.0**
Agriculture and Livestock	2.7	3.2	-6.2	4.2	3.5
Industry	-1.5	-6.3	-3.6	1.3	3.3
Services	1.0	-2.7	-2.5	0.4	2.7
Household Consumption	2.3	-3.9	-4.2	0.3	2.5
Government Consumption	0.8	-1.1	-0.7	-0.6	1.4
Gross Fixed Capital Formation	-4.2	-13.9	-9.8	3.8	6.0
Exports	-0.9	6.2	4.8	2.5	2.0
Imports (-)	-1.9	-14.1	-10.7	-0.7	2.2

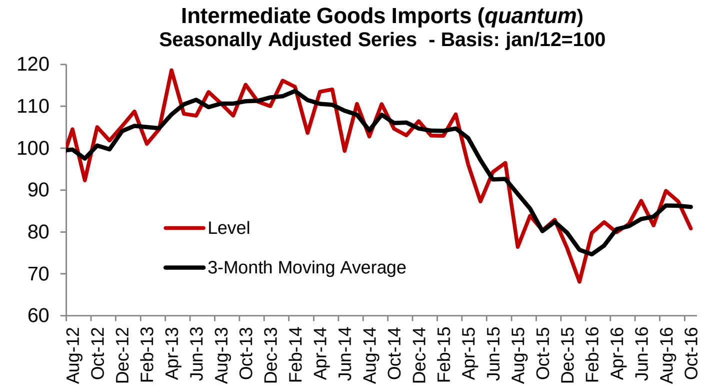
Source: IBGE and Santander forecasts

Disappointing Results in 3Q16

The most recent releases of economic activity indicators have brought disappointing results. For instance, industrial production growth returned to negative territory in 3Q, after 2Q16 interrupted a long sequence of eight consecutive declines. The dismal performance of durable goods and capital goods categories accounted for the largest part of the overall contraction, mainly reflecting the high debt levels of households and companies in a tight credit environment. In addition, net manufactured exports have lost momentum in recent months, reducing the positive contribution of industrial activities more linked to the external sector, which showed the first signs of recovery earlier this year.

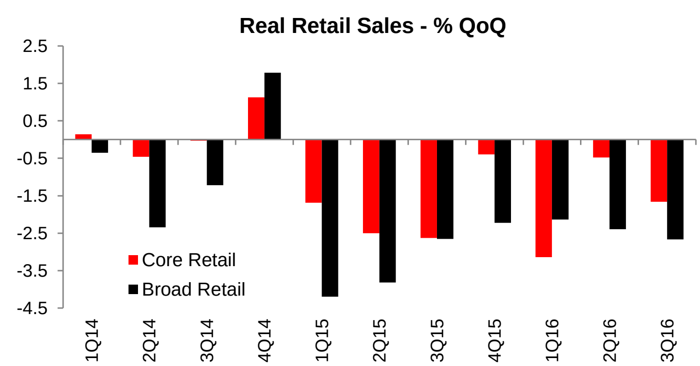


Source: Funcex

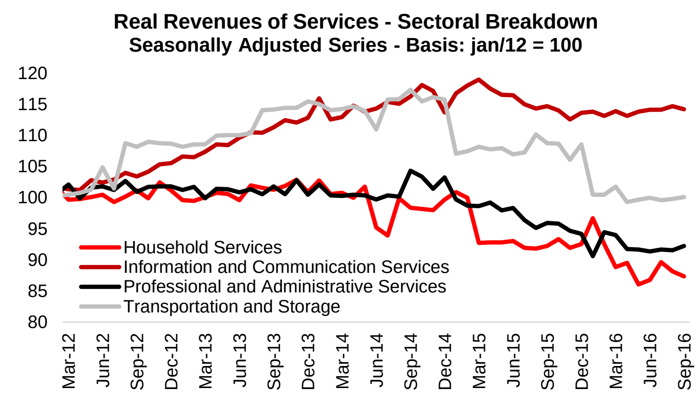


Source: Funcex

With respect to retail sales and services revenue, the main results were also not encouraging last quarter. The sharp deterioration in labor market conditions (more than 12 million unemployed people and around a 4% contraction in aggregate real wages) continues to weigh heavily on private consumption. Moreover, it is worth mentioning that uncertainties regarding the macroeconomic environment tend to intensify the precautionary behavior of households, mainly affecting the demand for durable goods (e.g., vehicles, furniture, home appliances, electronic products), which have been showing the worst growth rates in more than two years.



Source: IBGE
Note: Broad Index includes all segments of Core Index + "vehicles, motorcycles, auto parts ", and "building materials"



Source: IBGE

Reflecting the poor performance of the main productive sectors, Brazil GDP fell 0.8% q/q (-2.9% y/y) in 3Q16, for the seventh consecutive contraction in the margin. Hence, the current recession is the longest and deepest of the historical data series (which began in 1981) tracked by the CODACE (Committee to Date Economic Cycles).

In addition to the discouraging 3Q figures, the coincident indicators of October released so far (e.g., vehicles sales and production, flow of heavy vehicles on toll roads, paper cardboard dispatches also presented contraction, pointing to a shrinkage of domestic activity in 4Q, albeit at a much less intense pace. Our current forecast for 4Q GDP growth is -0.2% q/q, below the previous expectation of +0.2% q/q.

In other words, we now expect the real GDP variation to return to positive territory only in 1Q17. Therefore, we are revising downward our forecast for real GDP growth in 2016, to -3.5% from -3.3%.

GDP Breakdown	%YoY			%QoQ		
	1Q16	2Q16	3Q16	1Q16	2Q16	3Q16
Total GDP	**-5.4**	**-3.6**	**-2.9**	**-0.5**	**-0.4**	**-0.8**
Agriculture and Livestock	-8.3	-6.1	-6.0	-3.7	-0.8	-1.4
Industry	-7.0	-2.9	-2.9	-0.8	1.2	-1.3
Services	-3.5	-2.7	-2.2	-0.3	-0.6	-0.6
Household Consumption	-5.8	-4.8	-3.4	-1.5	-1.0	-0.6
Government Consumption	-0.8	-0.5	-0.8	0.3	0.0	-0.3
Gross Fixed Capital Formation	-17.3	-8.6	-8.4	-1.6	0.5	-3.1
Exports	12.7	4.0	0.2	4.8	-1.8	-2.8
Imports	-21.5	-10.4	-6.8	-1.5	2.8	-3.1

Source: IBGE

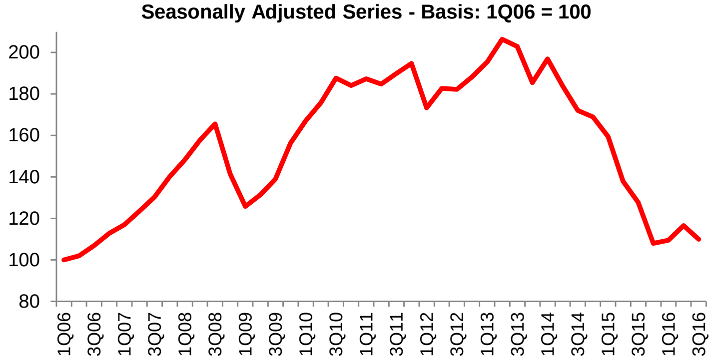
Looking ahead: the well-known U-shaped recovery

The downward surprises brought by economic activity indicators over 2H16 imply a notably negative carryover effect for GDP growth next year, in our view: we now calculate -0.7 pp, considerably below the previous estimate of only -0.1 pp, as stated in our last report on 2017 GDP growth revision, published in May (for more information, please see *Brazil under a New Administration*, May 13, 2016).

In addition to the worse statistical effect, it is worth noting the rising uncertainties about the global economy's dynamics (for more details, please see *President-elect Trump: What Now for Brazil?*, November 9, 2016) and further political turmoil on the domestic front in the recent period. Evidently, these factors increase risk perception and markets' volatility, which makes the expected resurgence of investments more challenging, in our opinion.

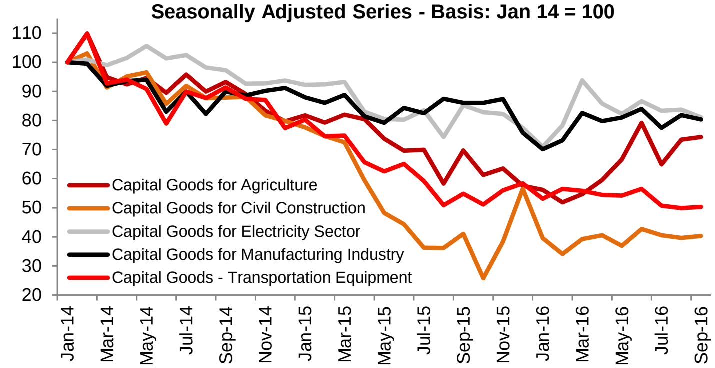
Considering the most recent results, there have been better signs in some capital goods categories, such as the positive trend in capital goods for agriculture and for the manufacturing industry. However, we must recognize that the overall performance of investments has been below expectations, especially with regard to the fragile scenario for civil construction and transportation equipment (trucks being the main example). **On the whole, we continue to foresee an expansion of gross fixed capital formation in 2017, but this process should be less pronounced than previously anticipated. In this sense, we point out that in our previous base case scenario, we expected the monetary easing cycle to start earlier and more forcefully than actually occurred.**

Apparent Consumption of Capital Goods
Seasonally Adjusted Series - Basis: 1Q06 = 100



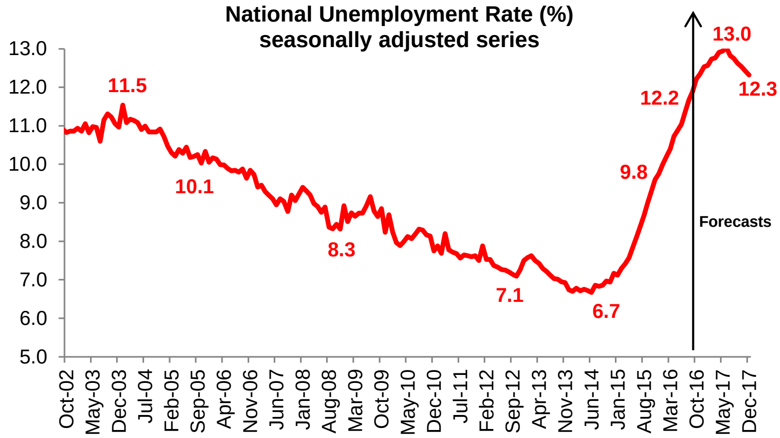
Source: IBGE

Capital Goods Production - Sectoral Breakdown
Seasonally Adjusted Series - Basis: Jan 14 = 100



Source: IBGE

Looking at the other GDP components, we do not see significant impulses for economic growth. First, we believe household consumption will continue to be discouraged by the aforementioned weakness in the labor market and credit concessions. For instance, we believe that the unemployment rate will peak only in 2Q17 (at around 13.0%) and thereafter should present a very gradual decline, reaching about 12.0% at the end of next year. In terms of public consumption, we believe the ongoing fiscal adjustment, which is crucial for a sustainable and robust recovery of the Brazilian economy, is unlikely to allow the government to adopt countercyclical measures in the coming year.

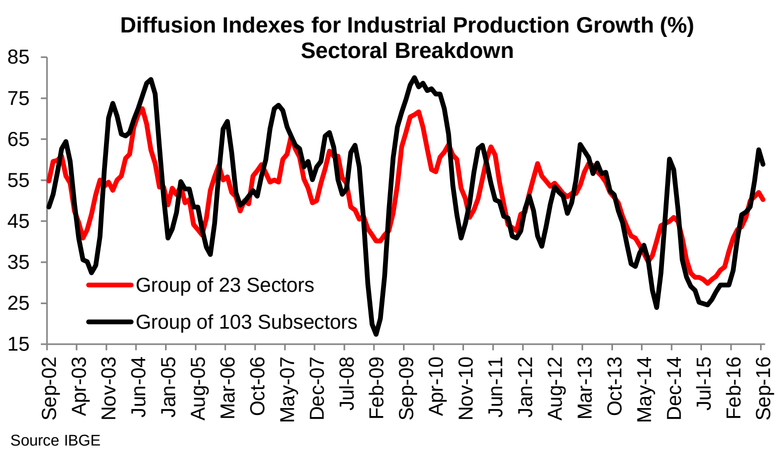


Source: PNAD (IBGE) and Santander estimates

Finally, the external sector should contribute positively to GDP growth in 2017, according to our projections, but much less significantly compared to the previous two years. On one hand, we expect: (i) the real exchange rate to depreciate ahead, which could reinforce the upward trend of some industrial segments that have been showing an increase of exports; and (ii) domestic income to stabilize, leading to a considerably smaller drop in imports. On the other hand, we believe world trade will likely remain weak (especially in a more uncertain and worrying international environment), and commodity prices are unlikely to show a vigorous rise. Hence, we think that net exports could bring additional relief to economic activity in 2017, but it not sufficiently to lead the resumption of growth.

Nevertheless, despite the still highly challenging environment for Brazilian economy, as described above, we cannot disregard the improvement of some important economic conditions. First, domestic inflation has been falling steadily, and we do not believe it will be reversed in the coming year, given the significantly negative output gap and anchored inflation expectations. Thus, even considering growing uncertainties about the pace of monetary easing (and its underlying effects on domestic activity), there seems to be a consensus that there is room for interest rates to fall ahead – we forecast that the Selic rate, currently at 13.75%, will reach 9.5% by the end of 2017, while market consensus expects it to be cut to 10.75% in the period.

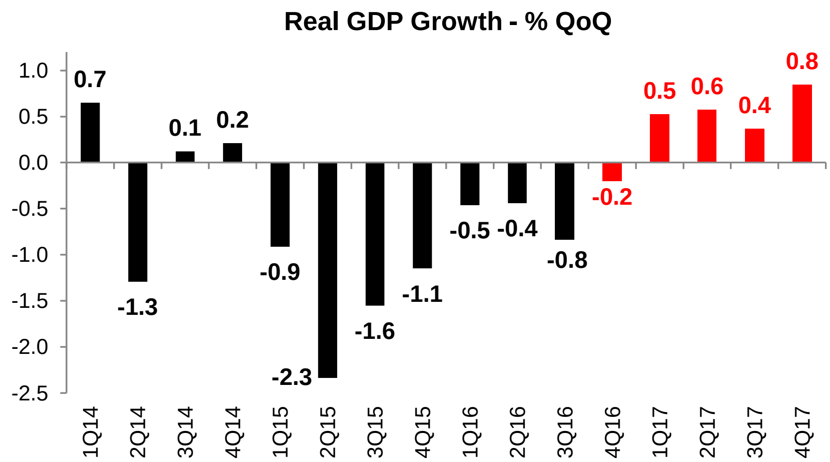
Furthermore, we have observed progress in fiscal adjustment agenda in Brazil over the last few months. Despite the recent round of political turmoil, we consider it unlikely that the government will not be willing to approve the necessary measures to balance public finances, in view of the rapid increase of the public debt-to-GDP ratio. Thus, we maintain our expectation of a further increase in business confidence next year–- albeit at a moderate pace – which would play a major role in the recovery of Brazilian industry and investments. And, intrinsically linked to this improvement, we also highlight the continued reduction of industrial inventories, which should tend to stimulate physical production over 2017; for instance, current inventories in the intermediate goods category – which represents around 50% of overall industry – are hovering around levels considered normal (no excessive inventories).



Source IBGE
Note: Estimates consider the moving quarter average - % QoQ

In addition to those more solid fundamentals, it is worth mentioning the highly positive outlook for agricultural activities. In contrast to the negative scenario of 2016, marked by several harvest failures (corn production being the main example), we forecast benign results for the primary sector in 2017, as already indicated by the first official estimates of production. Indeed, not only do we expect the production of raw materials to grow, but we believe agribusiness as a whole is likely to make a substantial contribution to economic activity next year. Looking at industry, the following activities have been showing a more favorable performance since 1H16, which we do not expect to see a reversal in the next year: food products; beverages; pulp and paper; biofuels; leather products; and wood products.

All in all, we reinforce our expectation that Brazil GDP will resume growth in 2017. Nevertheless, combining the latest round of activity variables with the recent turmoil in the international economic and political environment, we now forecast that GDP will grow 0.7% next year, significantly below our previous expectation of +2.0%. In other words, we forecast the Brazilian economy to return to positive territory in 2017, but this process will tend to be slow and gradual (a typical "U-shaped recovery").



Source: IBGE and Santander forecasts

For 2018, we maintain our expectation that GDP will grow 3.0%. In our view, the benefits of the monetary easing cycle will be much more evident in that year, as will the positive effects of infrastructure concessions and privatization programs. Furthermore, we believe private consumption should show a consistent recovery in 2018, albeit at a modest pace, given the expected stabilization of the labor market from mid-2017 onward. In addition, it is important to highlight the resumption we expect in durable goods sales, mainly due to an improvement in credit conditions and some relief in the household debt burden.

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Source: IBGE and Santander forecasts

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