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ECONOMICS April 27, 2017

Brazil—Economic Activity

The Recession Is Over: The Reasons Why

Rodolfo Margato*
rodolfo.silva@santander.com.br
5511-3553-1859

- **The deepest and longest recession of the Brazilian economy has come to an end, in our view. After eight consecutive quarters of decline, Brazil GDP expanded 1.1% q/q in 1Q17, by our estimate.**
- **That expectation is associated with the improvement of several macroeconomic fundamentals, but it is also due to specific factors whose positive effects will not be present in the next quarters, such as (1) the very strong expansion of Agriculture GDP and (2) the methodological review in the Monthly Services Survey, which is partially used in the calculation of GDP. In this report, we analyze the impact of these temporary shocks on the resumption of economic activity.**
- **Thus, with regard to the quarterly GDP dynamics, the 1Q17 growth rate should not be seen as an average pace for the following periods. Indeed, we continue to believe that the recovery of domestic activity will be moderate throughout this year.**
- **Furthermore, even taking into account the expectation of higher growth in 1Q17 (our previous estimate was +0.5% q/q), we maintain the scenario that Brazil GDP will grow 0.7% in full-year 2017, and for now we only assign a slight upward bias to that projection. The slower-than-anticipated pace of investment recovery in domestic economy and the addition turmoil in political environment support our decision to keep the forecast unchanged.**
- **Looking ahead, we reiterate the expectation that the Brazilian economy will expand by 3% in 2018, owing to the further improvement on the macroeconomic side (e.g., inflation expectations below the inflation target; real interest rate substantially lower than in recent years; rising consumer and business confidence) as well as more efficient microeconomic measures (e.g., concessions and privatizations in the infrastructure sector; agenda for credit cost reduction; agenda for greater efficiency of monetary policy).**

GDP Breakdown - Supply Side

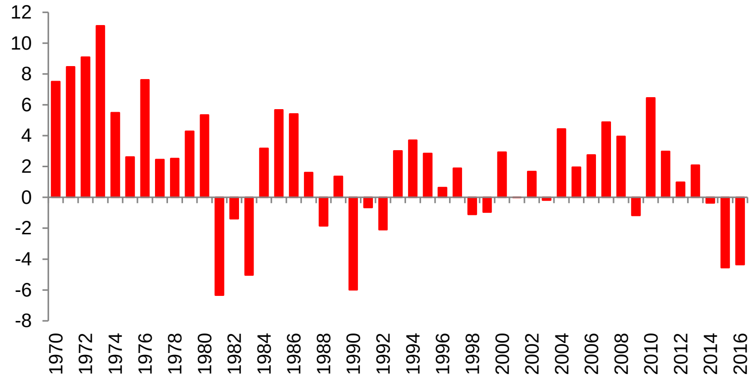
	%QoQ					%YoY	
	1Q16	2Q16	3Q16	4Q16	1Q17 F	2017 F	2018 F
Total GDP	**-0.6**	**-0.3**	**-0.7**	**-0.9**	**1.1**	**0.7**	**3.0**
Agriculture and Livestock	-3.2	-1.0	-2.1	1.0	11.5	7.0	3.5
Industry	-0.8	1.0	-1.4	-0.7	0.7	1.3	3.3
Services	-0.4	-0.7	-0.5	-0.8	0.5	0.3	2.7

Source: IBGE and Santander Forecasts

Nothing (Bad) Lasts Forever

We have been increasingly confident that the recession ended earlier this year. As we noted in previous reports (e.g., "Maintaining the Route but Adjusting the Speed: A Gradual Economic Recovery", December 12, 2016)**, the recessionary cycle started in mid-2014 can be seen as the deepest and longest of the available historical data series.** Per capita GDP plunged around 9.0 pp over this period, a result even worse than that observed in the so-called "lost decade" of Brazilian economy (-6.8 pp from 1981 to 1992). Nevertheless, we believe that the domestic activity has finally bottomed out. After the disappointing results of 4Q16 GDP, the most recent round of monthly economic activity indicators showed signs of recovery.

***Per capita* GDP - Real Annual Growth (%)**



Source: IBGE and Santander estimates

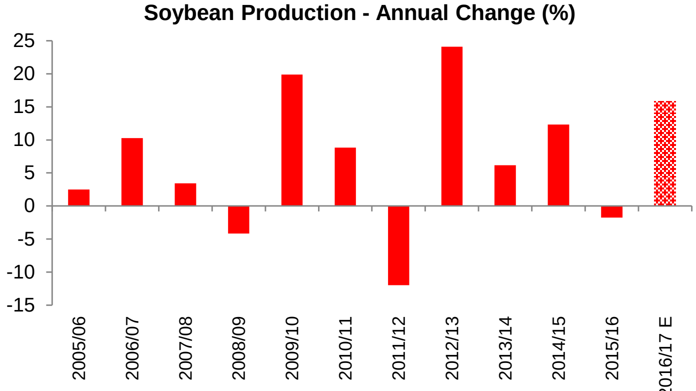
Accordingly, we estimate that Brazil GDP expanded by 1.1% q/q in 1Q17, interrupting a long sequence of eight consecutive declines on this basis of comparison. This expectation is associated with the improvement of several macroeconomic fundamentals, such as the (1) consistent and widespread decline in inflation; (2) lower risk perception on the economic environment; (3) sustainable easing of monetary policy; and (4) stabilization of real wages. However, we think that the relatively strong growth rate in the last quarter is also due to specific factors (detailed in this report) that should not be repeated in the coming quarters, and therefore we do not change the prognosis that the recovery of Brazilian economy will occur at a moderate pace throughout 2017.

Great Start to the Year: Comments on Agricultural Harvest, Carryover Effect and Methodological Review

1. The Harvest of Salvation

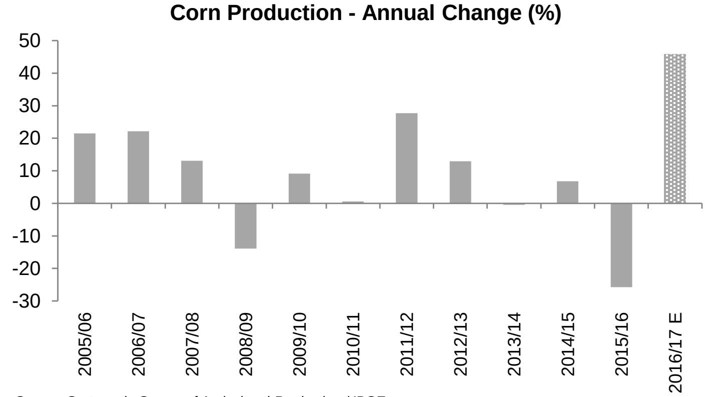
First, we highlight the record agricultural production in the 2016-17 season, contrasting with the very depressed output levels registered in the previous period. **Good climate conditions and the subsequent sharp increase of productivity explain the very auspicious estimates for grain production in virtually all regions of the country.** In this sense, the soybean and corn harvests are expected to grow at double-digit rates in the current season, leading the Agriculture and Livestock GDP to boom in 1Q17 (in-line with the seasonal pattern in the calculation of these crop harvests in GDP accounts). Taking into account the latest surveys for 2016-17 agricultural crops, we estimate that the Agriculture and Livestock GDP boosted by 11.5% q/q last quarter, which means a contribution of 0.6 pp to overall GDP growth in the period (i.e., more than 50% of the expected total increase). For the next quarters, in turn, we foresee much more subtle contributions coming from the primary sector.

Soybean Production - Annual Change (%)



Source: Systematic Survey of Agricultural Production / IBGE

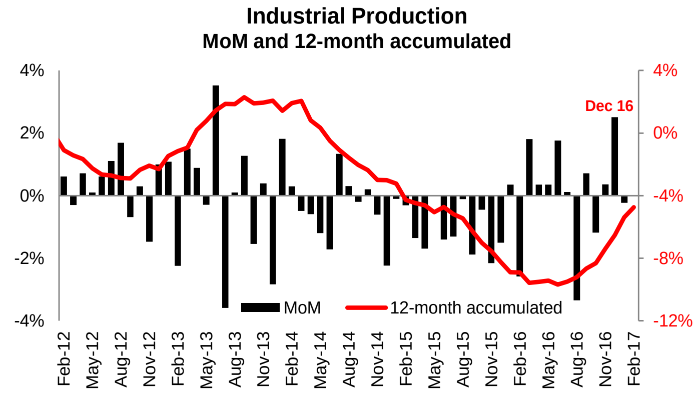
Corn Production - Annual Change (%)



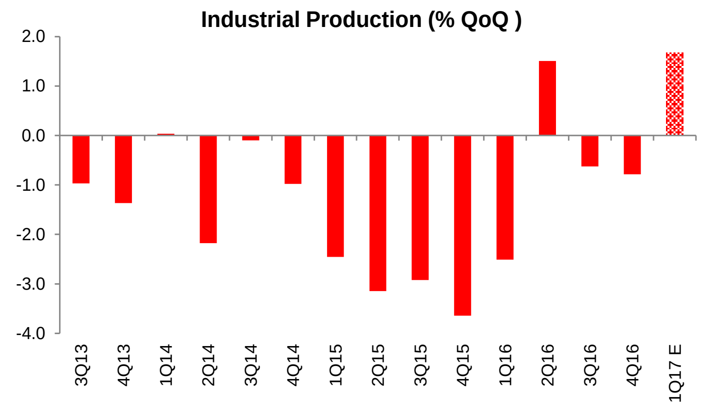
Source: Systematic Survey of Agricultural Production / IBGE

2. Unlocking the Gears

In addition to the extraordinary agricultural production, the industrial sector is also showing more favorable signs, albeit rather moderately. The end of the inventory adjustment cycle in several manufacturing activities, mainly in intermediate goods and durable goods categories, recovery of the export quantum, and improvement in prospects for the domestic demand (allowing continuous rise in business confidence) seem to have interrupted the negative trend of local industry. **These factors coupled with the very positive carryover effect from the December 2016 results (+2.5% m/m) led the total industrial production to grow 1.4% q/q in 1Q17, according to our estimates. Thus, although we project a gradual recovery of Brazilian industry over this year, since consumption and investments remain at low levels, we reiterate our view that its trend is pointing north.**

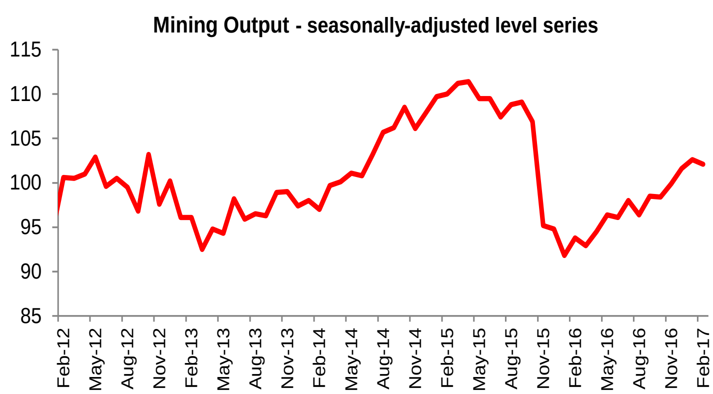


Source: Monthly Survey of Industry /IBGE

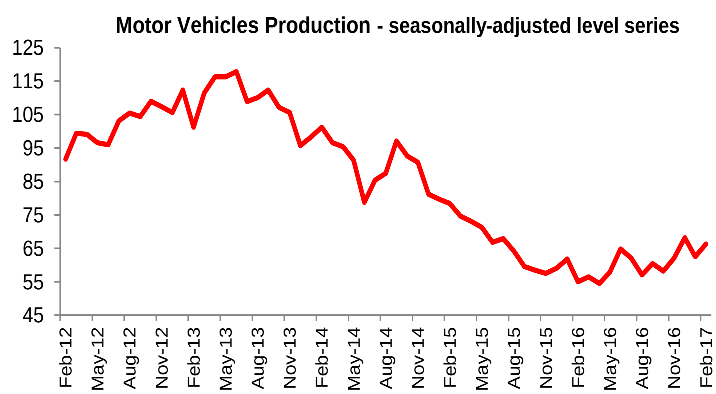


Source: Monthly Survey of Industry /IBGE and Santander forecasts

Concerning the industrial breakdown, note the strong expansion in mining and oil production, as well as the stabilization of the automotive industry. Regarding the latter, the recent improvement has been mostly driven by the surge in vehicles exports, as the domestic sales have not yet resumed growth. Nevertheless, the easing financial conditions and rising consumer confidence will likely unlock the local demand by the end of this year. On the opposite side, civil construction continues to exert a negative contribution to overall industry, and it should show a later recovery.



Source: Monthly Survey of Industry / IBGE

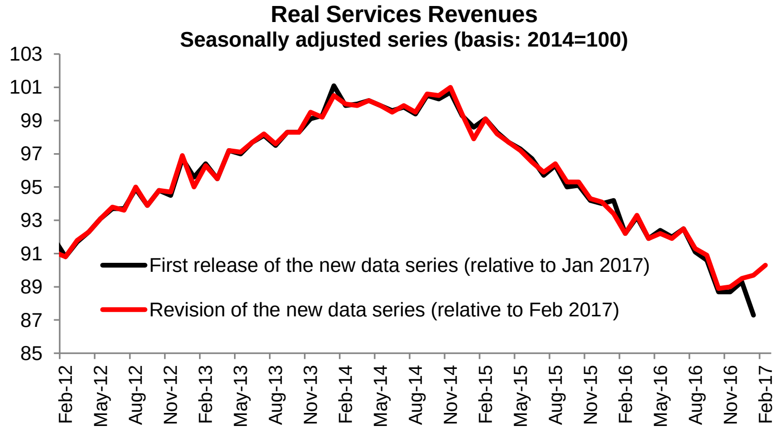


Source: Monthly Survey of Industry / IBGE

3. The Benefit of the Review

The most intriguing debate on the GDP supply side is the recent performance of the services sector, which accounts for around 70% of total GDP, excluding net taxes on products. On this subject, we must discuss the latest methodological review of the Services Monthly Survey (PMS, the acronym in Portuguese) published by the Brazilian Institute of Geography and Statistics.

In short, all the economic indicators related to the services segments (e.g., PMS and Quarterly National Accounts) had been showing the same scenario: further deterioration, albeit at an increasingly mild pace, and no consistent sign of growth resumption, reflecting the fragile labor market and still-high levels of household income burden. However, the latest release of PMS, containing data for February, brought significant upward revisions to the performance of most services activities in the recent period. For instance, the total services revenues growth in January was revised from -7.2% y/y (-2.2% m/m) to -3.5% y/y (+0.2% m/m). In fact, the updated version of the PMS shows continued expansion in real services revenues in the last four months, suggesting an upward path. Although methodological changes are welcome to bring more up-to-date information on economic activity, we argue that the most recent PMS data should be treated with caution, especially with regard to the measurement of Services GDP. In fact, there is high uncertainty as to how IBGE will incorporate the methodological revisions in the calculation of GDP[1].



Source: Services Monthly Survey / IBGE

As pointed out in the *1Q17 Inflation Report* published by the Central Bank of Brazil, the activities covered in the PMS correspond to around 30% of the total value-added of the services sector in GDP, and that correspondence is concentrated in three segments in the Quarterly National Accounts: "transportation," "communication" and "other services." Thus, the aggregate indicator from the PMS is not an effective proxy to anticipate the dynamics of the Services on GDP. That discrepancy between the surveys is related to their coverage and weighting of activities. Regarding the former reason, we note that the PMS is a firm-level survey based on the gross revenue from services in formal companies, employing 20 or more persons, in which the main activity is nonfinancial services, while the National Accounts information is derived from several sources and comprises data from the informal sector and from firms of all size levels. In other words, **the National Accounts have a much larger breakdown than the data available in the PMS, and the recent methodological changes in the latter should not heavily affect the 1Q17 GDP result.**

Participation of the activities in services sector (%) Services Monthly Survey (PMS) x Quarterly National Accounts		
Activities	**PMS ***	**National Accounts ****
Information and communication services	35.7	4.8
Services rendered to households	6.4	6.1
Professional, administrative, and complementary services	20.5	11.4
Transportation and storage	30.7	6.4
Others	6.7	71.3

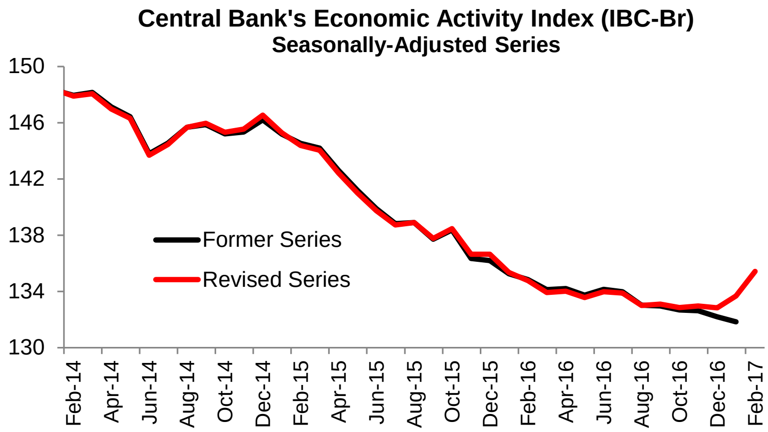
* Estimates based on gross revenues
** Estimates based on gross value-added
Source: IBGE and Central Bank of Brazil

In the light of the topics set out above, we believe that (1) the services sector has stabilized in the recent months; (2) 1Q17 Services GDP increased in quarter-over-quarter terms (it is still negative on the annual comparison), but at a much lower rate than that suggested by the Services Monthly Survey; (3) most services activities will show a consistent upward trend from 2H17 onward, in the wake of the stabilization in domestic labor market and improvement of household financial conditions; and (4) although we do not give much weight to the methodological changes, they should exert some positive contribution to 1Q17 GDP growth. (We estimate a net contribution of 0.3 pp.)[2]

[1] The methodological review of the PMS, which was already foreseen, consisted of the use of data from the Annual Survey of Services—2014, replacing the Annual Survey of Services—2011. Among the changes, we highlight that: (1) the sample respondents were updated; and (2) the indexes from January 2012 to December 2016 maintained the base year in 2011, while the indexes from January 2017 onwards started having the base year in 2014. Regarding the latter, it is worth noting that the first release based on the new methodology (relative to January 2017) led to results far below the expectations. Thus, having data for February, IBGE decided to recalculate the base year of the structural survey, which culminated in strong upward revisions to the January results.

[2] In simplified terms, based on the PMS, we compared the actual results of the real revenues services in January and February to our forecasts developed from antecedent and coincident indicators that are relevant to the services sector (e.g., services confidence index; real wages; industrial production). That method was applied to the three services segments that are included in both the PMS and Quarterly National Accounts.

Central Bank's Economic Activity Index (IBC-Br, the acronym in Portuguese), which serves as a monthly proxy for GDP, also presented a strong revision in its recent data. By incorporating the information of the new Services Monthly Survey and Retail Monthly Survey[3], IBC-Br showed a much more benign performance of domestic economic activity at the beginning of this year. For example, IBC-Br variation in January was revised from -0.3% m/m to +0.6% m/m, which combined with the 1.3% m/m expansion registered in February implies a carryover effect (i.e., assuming null variation in March) of +1.5% q/q in 1Q17.



Source: Cental Bank of Brazil

Take It Easy: It Will Grow, but Gradually . . .

In addition to the sectoral drivers presented above, we highlight that the release of 1Q17 GDP results will lead to a non-negligible revision of GDP variation in the previous quarter (to -0.6% q/q from -0.9% q/q, according to our estimates), given the change in seasonal factors. Hence, the carryover effect for 2017 GDP growth will likely be +0.3 pp, well above the statistical effect of -1.1 pp resulting from 4Q16 numbers.

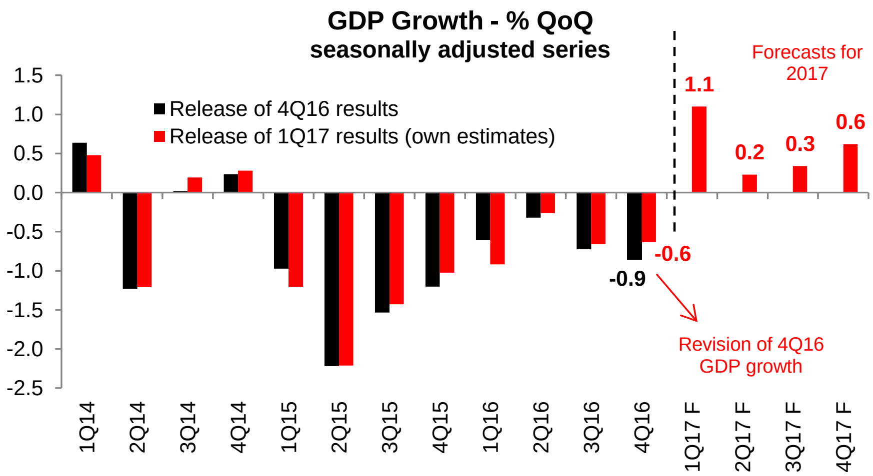
Nevertheless, we reinforce that some of the key drivers for 1Q17 GDP growth will not be present in the coming quarters, particularly with regard to the strong contribution from the agricultural production**.** In addition to the fading effects of the temporary shocks seen in the last quarter results, we note (1) the slower-than-anticipated pace of investment recovery in domestic economy and (2) the addition turmoil in political environment. Regarding the latter, the increasing uncertainties about the government's ability to continue implementing fiscal adjustment measures—Social Security reform plays the major role—consist of the main risk to our base-line scenario of sustainable economic growth ahead. (For details, please see our "Report on the Social Security Reform Proposal: A Risky Strategy", April 20, 2017.)

Thus, in spite of the expectation of higher growth in 1Q17 (our previous estimate was +0.5% q/q), we maintain the scenario that the Brazilian economy will grow 0.7% in full-year 2017, and for now we only assign a slight upward bias to that projection. That said, we think that the market consensus for 2017 GDP growth, which is currently at 0.43%, will rise in the coming weeks.

Regarding the quarterly GDP dynamics, the 1Q17 growth rate (in quarter-over-quarter terms) should not be seen as an average pace for the following periods. Indeed, we continue to believe that the resumption of domestic activity will be moderate throughout this year.

But despite the relatively low growth rates expected for the coming quarters, which are also due to the strong comparison base left by the 1Q17 result, we think that the economic recovery will be much more widespread and robust in 2H17, mainly owing to the unlocking of the credit market (bearing in mind its lagged reaction to the easing monetary policy) and effective stabilization of the labor market. (For more information, see our study "Will Deleveraging Limit Credit Growth?" February 2, 2017.)

[3] Similarly, the Retail Monthly Survey was also revised earlier this year. In short, there was an update of the sample respondents and weights of retail activities, based on the replacement of the Annual Survey of Retail 2011 by the Annual Survey of Retail 2014. As in the case of PMS, IBGE decided to recalculate the base year after having data for February 2017, which led to significant upward revisions to the January 2017 results. For example, the real growth rate of core retail sales in January was revised to +5.5% m/m (-1.2% y/y) from -0.7% m/m (-7.1% y/y). Despite that strong revision, we do not expect relevant impacts on the 1Q17 Commerce GDP (which is included in the Services GDP) to be published in the Quarterly National Accounts. The reason is that the added value of such GDP component is calculated from the commercialization margins of the other sectors, not using the Retail Monthly Survey data as a primary source.



Source: IBGE and Santander forecasts

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Source: IBGE and Santander Forecasts

While acknowledging the growing risks from the political scenario, we reiterate the expectation that Brazil GDP will expand 3% in 2018, owing to the further improvement in macroeconomic side (e.g., inflation expectations below the inflation target; real interest rate substantially lower than in recent years; rising consumer and business confidence) as well as more efficient microeconomic measures (e.g., concessions and privatizations in the infrastructure sector; agenda for credit cost reduction; agenda for greater efficiency of monetary policy[4]).

[4] For more information, see our report "De-Jaboticabizing" Brazil, Part I: End of TJLP is a First Step Toward More Rational Credit Market, April 24, 2017.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.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
Brendan Hurley	Economist - Colombia	bhurley@santander.us	212-350-0733
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537
Fixed Income Research			
Brendan Hurley	Macro, Rates & FX Strategy – Latin America	bhurley@santander.us	212-350-0733
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Nicolas Kohn*	Macro, Rates & FX Strategy - LatAm	nicolas.kohn@santandergbm.com	4420-7756-6633
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
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264
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