Santander

ECONOMICS

March 2, 2018

Brazil Macro Compass

Brazil Growth: Not Quite Out of the Woods

Luciano Sobral*
lusobral@santander.com.br
+5511 3553 3753

What's New: 2017 GDP Growth at 1%; We Still See 2018 Growth at 3.2%

GDP numbers for 4Q17 and full-year 2017, released this week, were slightly disappointing: **Quarterly growth in 4Q17 was only 0.1%, below our estimate (0.4%) and market consensus. Full-year growth was 1.0%** — not eye-catching, but the strongest since 2013 and higher than what was expected six months ago (in July 7, 2017, consensus, according to the Central Bank Focus survey, was at only 0.34%).

Looking at the breakdown, we see that household consumption was the main source of disappointment, growing only 0.1% in the quarter. Investments, on the other hand, confirmed the rebound started in 3Q17 (see more on this in the Chart of the Week on the following page). Agriculture surged 13% in 2017 and explains almost 70% of total growth, from a supply perspective.

What now? We believe that our 2018 GDP growth forecast (3.2%) still can be proven accurate. Although the carry-over effect from 2017 could be weaker than we were expecting (only 0.3%), **we believe that quarterly growth will average 1.0% throughout 2018.** Our forecast is compatible with improving macro fundamentals (low inflation and rates, rising real wages, and deleveraged households and firms) and the most recent high frequency indicators. However, both this release and the most recent data do not reconcile with the more sanguine estimates (around 4.0%) of our clients and competitors. We continue to expect a very gradual — though now more solid — recovery.

The bright side of slow growth is that inflationary pressures stemming from demand are likely to remain contained, in our view (output and unemployment gaps remain wide; for details see our November 16, 2017 report, *Core Inflation Expected to Remain Comfortably Below 4% in 2018 and 2019*)**, allowing the Central Bank to, in our view, cut rates in March** (we expect the Selic rate to end this cycle at 6.50**%**) **and to keep a loose monetary policy stance until 2H19**. For our latest update on monetary policy, see our February 15, 2018 report, *Even Better than the Real Thing*.

January payroll data, released this Friday, showed that net formal job creation has been positive for the fourth straight month (after seasonal adjustments), providing evidence of the economic rebound's consolidation (formal job creation usually lags other activity indicators) and the job market's slow recovery (at this pace, we expect the unemployment rate to reach 10.8% from the current 12.2% by year end).

Upcoming Data: Inflation Still Below Target; Industrial Production

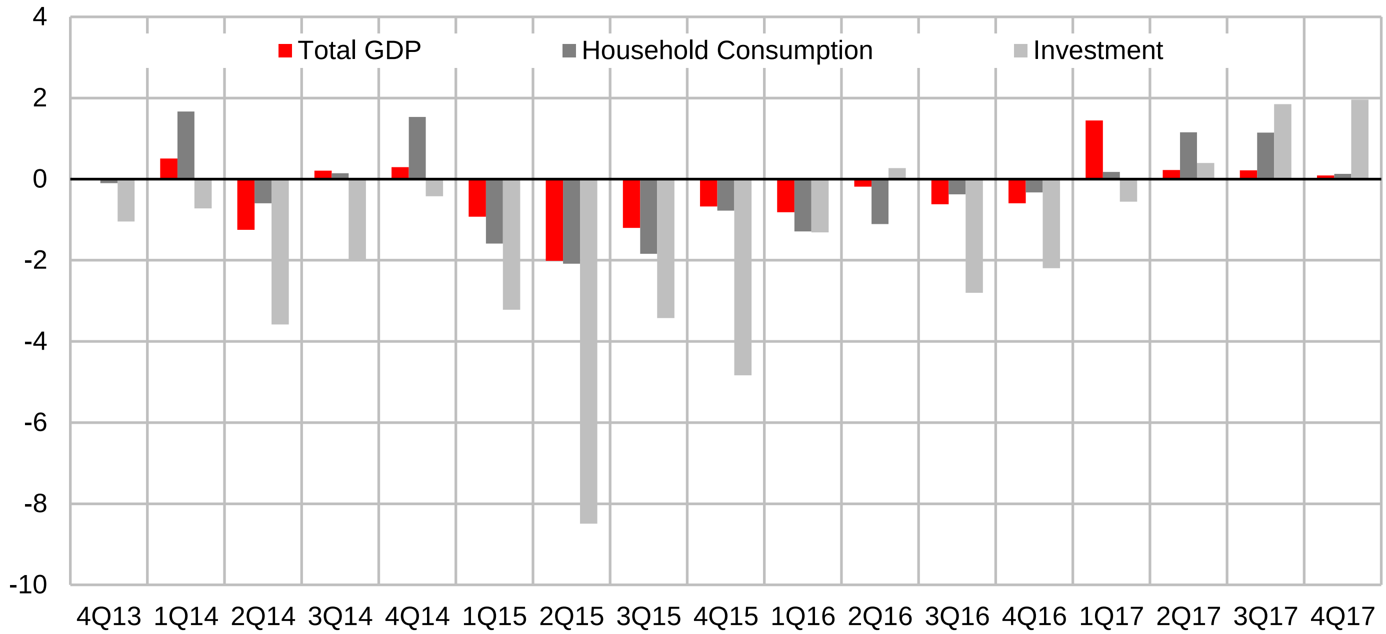
February official CPI inflation (IPCA) will be released next Friday (March 9). We expect monthly inflation at 0.33%, which would be the lowest for the month since 2000 and 18 bps below the Central Bank's estimation reported in December's Quarterly Inflation Report. The normalization of food prices has been slow, and core inflation should remain in a downward trend, according to our projections. We expect 12-month inflation to slightly decelerate to 2.81% (from 2.86% in January), still below the bottom of the Central Bank's target (3.0%). This will be the last piece of IBGE inflation data before the next Copom meeting on March 21 (more on monetary policy in the previous section).

January industrial production, to be out on Tuesday, should fall 2.3% in monthly terms, according to our projections, smoothing out the extraordinary December rise (+2.8%). **We expect year-over-year growth to remain solid, at 5%**, with the pace of growth being maintained until year end and industry contributing about one-fourth to our GDP growth forecast.

Chart of the Week: The Resurgence of Investment

Investment growth, as measured by the national accounts, has been gaining momentum: 4Q17 was the second straight quarter of gross fixed capital formation growing around 2% q/q (and the first quarter showing year-over-year growth since 1Q14). The carry-over in investments for 2018 is 2.5% growth, on top of which we expect further acceleration to 7% growth for the full year, which should contribute 1 p.p. to our 3.2% GDP growth forecast. Nevertheless, gross capital formation as a share of GDP fell to 15.6%, the lowest since 2000, and its level is still 27% below 2013's peak. **Rising investment should be a top item in any long-term economic agenda to be debated during the elections, in our view.**

Quarterly GDP growth (%, seasonally adjusted)



Sources: IBGE, Santander

Political Agenda

The Speaker of the Lower House may try to call for a vote next week on the bill that would end payroll tax breaks for several sectors. This would require approving an urgency request to submit the bill directly to a floor vote. However, the government was already defeated in this matter last year (a decree reinstating the taxes expired without a vote in Congress), and representatives may be reluctant to raise taxes a few months before elections. **This year's budget relies on BRL12.3 billion in revenue from the reinstatement of payroll taxes.**

Also **next week the "party window" (a period in which sitting representatives in the Lower and Upper houses are freely allowed to change political parties) opens, to be closed on April 7.** The net results of the changes will be very relevant in evaluating the relative strength of the parties, as 65% of the resources of the public election campaign fund will be distributed according to the latest share of each party in both Congressional houses. The negotiations between parties and politicians should crowd out most of the legislative agenda during March, in our view.

Number of the Week

11 The number of fiscal rules, laws or constitutional provisions to which the Brazilian government must abide, as compiled by the Senate's Independent Fiscal Institution (IFI) in its January monthly report.

Quote of the Week

In Brazil, second to soccer, everyone wants to discuss the Selic rate.

Central Bank governor Ilan Goldfajn, quoted by *Exame* magazine online.

What We've Been Reading

- *The Industrialization of South America Revisited: Evidence from Argentina, Brazil, Chile and Colombia, 1890-2010*, by Gerardo della Paolera, Xavier H. Duran Amorocho, and Aldo Musacchio. (NBER Working Paper No. 24345). New manufacturing GDP time series are used to retell the bumpy story of industrialization in four South American countries.
- *"Harvard Blew $1 Billion in Bet on Tomatoes, Sugar, and Eucalyptus"*, by Michael McDonald and Tatiana Freitas (Bloomberg BusinessWeek). Harvard's endowment invested in farms in Brazil, among other money-losing enterprises.
- *OECD Economic Surveys: Brazil 2018*. A new and comprehensive report on the country's economic challenges. Not surprisingly, raising investment and fostering integration into the world economy are among the top recommendations.
- *Edited Democracy? Evidence of Media Slant in the Coverage of Presidential Debates*, by Alexsandros Cavgias, Raphael Corbi, Luís Meloni, and Lucas M. Novaes (preliminary draft paper). An attempt, using a clever identification strategy, to quantify how the famous edition of a decisive 1989 presidential election debate influenced voting results. (Spoiler alert: a lot, but probably not enough to change the election's result.)
- *North Korea and the Brazil passports: Why were they used by the Kims?,* by Becky Branford (BBC News). North Korean leader Kim Jong-un and his father supposedly obtained fake Brazilian passports in the 1990s. Kim Jong-un and his brother might have used Brazilian documents to enter Japan and visit Tokyo Disneyland in 1991.

Recent Publications (Available on Our Website)

- *One-Off Is Not Enough* (February 20, 2018)
- *Even Better than the Real Thing* (February 15, 2018)
- *Social Security Reform: Same Proposal. Different Probability?* (February 8, 2018)
- *Why Has the BRL Weakened in 2017?* (January 8, 2018)

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
Diana Ayala	Economist - Colombia	diana.ayala@santander.us	212-350-0979
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

Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan Miguel 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
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

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: Luciano Sobral*.

*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.