ECONOMICS

February 28, 2020

Brazil Macro Compass

Risk Aversion Goes Viral

Ana Paula Vescovi* and
Brazil Macroeconomics Team
anavescovi@santander.com.br
+5511 3553 8567

- **The global sell-off this week led the DI curve to steepen further, with the short end no longer pricing Selic hikes this year. Nonetheless, the possibility of a resumption of the easing cycle will probably remain alive in the next couple of months, in our view, especially if economic activity continues to disappoint.**
- **Next Wednesday 4Q19 GDP data will be released, and we believe it should confirm the frustration reflected by the coincident indicators in the period. We expect 1.5% growth compared to 4Q18 and disappointing 0.4% growth compared to 3Q19 (after seasonal adjustment), implying 1.1% full year growth in 2019. Despite this, we believe that the composition of the modest Brazilian GDP growth will be quite encouraging.**
- **Once again, we expect the trade balance outcome to be affected by imports of oil platforms, as indicated by weekly figures. Were it not for that factor, imports would be growing around 6.0%, which is compatible with our estimate of a USD38.0 billion surplus in the trade balance for the year.**
- **The public sector primary surplus in January 2020 was the best result for the first month of the year in the entire historical series (started in 1997). However, we think this figure should be taken with a pinch of salt, in view of the large contribution from atypical and temporary factors.**

Brazil local rates performed relatively well during the global sell-off this week—evidence, in our view, that markets see the net effect of the coronavirus shock as deflationary and that positioning, especially among foreigners, has been relatively light. The curve continued to follow this month's steepening trend: short tenors (up to Jan. 22) tightened (with Jan. 21 now trading at the same level of the overnight rate), whereas the long end widened about 10 bps. The most important driver from now on, in our view, will be the BCB's reaction in setting monetary policy. The possibility of a resumption of the easing cycle will probably remain alive in the next couple of months, in our opinion, especially if economic activity keeps disappointing. We continue to believe that, in that scenario, outright receivers in the short end are preferable to the long end and slope trades.

Brazilian GDP 2019: Next Wednesday (03/04), 4Q19 GDP data will be released, and we believe it should confirm the frustration reflected by the coincident indicators in the period. We expect 1.5% growth compared to 4Q18 and disappointing 0.4% growth compared to 3Q19 (after seasonal adjustment), implying 1.1% full year growth in 2019. The preliminary expectation was for strong GDP growth in the last quarter of 2019, due to the temporary increase in income owing to withdrawals from FGTS (private workers' mandatory savings fund). However, activity indicators for this period—notably November and December—were notably disappointing for most economic sectors. In our view, the impact of the FGTS stimulus must have been less than expected, for two main reasons: **(i)** some of the expected increase resulting from this temporary incentive was anticipated in 3Q19; and (**ii)** only about 75% of the available funds were withdrawn, whereas we expected the withdrawal of almost the entire available amount.

Despite this, we believe the composition of the modest Brazilian GDP growth will be quite encouraging. We estimate that household consumption and investments grew 2.0% and 2.1%, respectively, in 2019. In addition, in line with current fiscal constraints, government consumption decreased by 0.6% in the same period, according to our estimates. All in all, we believe the growth observed last year was based on the private sector, with domestic absorption growing 1.5%. On the other hand, on the external front, last year was marked by a slowdown in global growth, trade wars, and a series of crises in South American countries (an important destination for Brazilian exports), especially in 4Q19. Hence, we estimate a considerable negative contribution from the external sector both for 4Q19 (-1.2%) and for 2019 as a whole (-0.6%).

After the release of 2019 GDP data, we believe market participants will be focused on the pace of growth in the current quarter (which includes the months of January, February, and March).

The first 2020 economic activity indicators support our proposition that, once the impact of the temporary income stimulus has ended, we will see a GDP slowdown in 1Q20. Moreover, we consider that the effects of the one-off slowdown in global growth—resulting from a halt in the supply chain due to the coronavirus outbreak—could hurt Brazil's economic activity. However, the extent of the negative impact depends on the intensity and duration of the outbreak. As this remains uncertain, we believe this risk factor requires careful monitoring.

Despite the recent increase in uncertainty regarding global and local economic growth, we continue to expect faster growth in Brazilian economic activity this year compared to last year.

Labor market: According to the PNAD household survey, the national unemployment rate stood at 11.2% (of the economically active population) in the three-month moving average ended in January. This result was in line with consensus (and our) estimates. The outcome was 0.8 p.p. below the reading seen in the same period of 2019, suggesting a certain acceleration in the decline in joblessness in YoY terms. The seasonally adjusted and sequential jobless rate also moved lower, reaching 11.5%, according to our own calculations—the lowest level since 2Q16. Nonetheless, the unemployment rate remains high, standing well above the natural (or structural) level for the Brazilian economy, which we estimate at approximately 9.5%.

Regarding the composition of this job recovery, we see signs of improvement. First, the data shows some (slight) acceleration in the pace of expansion of the employed population in the last few months, with YoY and QoQ growth of 2.0% and 1.5%, respectively (seasonally adjusted, annualized rate). This pace tops the expansion rate of the labor force. The labor market participation rate has been stable, remaining close to the historical average (62.0%). Second, the informality rate reached 40.7% of the employed population, compared to 41.2% in the previous quarter.

In terms of wages, the survey shows stability in real income growth (adjusted for inflation). The real wage bill adjusted for inflation grew at a clip of 2.2% YoY in Jan/20. Given that the unemployment rate remains moderately above the natural level, we continue to project moderate growth in real average income.

Like the rest of the economy, the labor market should continue to recover gradually, according to our forecast. While an excess of labor tends to keep a lid on the expansion of average income, a greater share of formal employment tends to prop up consumption. We expect to see further declines in the unemployment rate (notably in the second half of the year), increasingly favored by formal jobs.

Trade balance: The Foreign Trade Secretariat—dubbed SECEX in the Portuguese acronym—usually carries out revisions in the figures of the trade balance, which are released on a weekly basis in Brazil. This time, the release of third week data included a significant revision in import outlays, which led to an increase of USD1.2 billion in those expenditures. A more thorough assessment of data unveiled that that increase was related to imports of oil platforms, which has more to do with the end of fiscal incentives than with the sheer growth of imports resulting from an economic recovery. When one factors out that influence, imports are growing in line with our expectation, which points to a USD38.3 billion surplus in 2020, vs. USD46.7 billion in 2019. Therefore, although below the USD3.3 billion surplus registered last year, the USD1.3 billion positive trade balance in February 2020 still implies less dramatic dynamics of foreign trade for the current year, in our view.

Fiscal balance: As published by The National Treasury Secretariat (STN in the Portuguese acronym), the Brazilian central government recorded a primary surplus of BRL44.1 billion in January 2020, significantly higher than the positive balance registered in the same month of last year (BRL30.0 billion). This result came in above our expectation (BRL41.5 billion) and market consensus (BRL38.0 billion).

Both the strong performance of tax collection and the low execution of expenses explain the notable increase in the primary result earlier this year. With respect to the revenue side, we highlight the sharp expansion in income tax (from companies and individuals) and the contribution from net profits in January—as released by The Federal Revenue Service of Brazil last week—in the wake of corporate reorganizations (asset sales) carried out by state-owned companies and net individual gains from trading on the stock markets in the recent period.

On the expenditure side, the pace of execution in January 2020 was well below that observed in the same month in the last few years, mostly reflecting the changes related to public budget management in a context of greater control by Congress: 2020 is to be the year of implementation of the so-called "mandatory budget," in which the legislative branch (in the form of parliamentary amendments) has more control over execution of primary expenses. Remaining doubts about the actual amount of budgetary resources to be made available through amendments (mainly amendments defined by the Budgetary Law's Rapporteur), combined with political friction between the executive and legislative branches related to the new budget management framework, explain the slow pace of expenditure execution.

Thus, the central government's primary result in January 2020 should be taken with a pinch of salt, in our view. Although we foresee stronger growth in tax revenue this year, in line with the ongoing recovery in domestic activity, we expect the central government's 2020 primary deficit to be worse than that registered in 2019, which was highly influenced by a large amount of nonrecurring revenue. We forecast a negative balance of BRL107.5 billion (-1.4% of GDP) for the current year (budget target: -BRL124.1 billion, or -1.6% of GDP).

Lastly, the consolidated public sector unveiled a primary surplus of BRL56.3 billion in January, with the following breakdown: BRL45.5 billion for the federal government; BRL10.1 billion for states and municipalities; and BRL0.7 billion for state-owned companies. As aforementioned, the magnitude of the improvement in fiscal accounts last month should not be extrapolated for the rest of the year—we anticipate a negative primary balance of BRL98.5 billion (-1.2% of GDP) in 2020, following the primary deficit of BRL61.9 billion (-0.9% of GDP) seen in 2019.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: They Have Not Got It (Yet)* (February 20, 2020)
- *Macroeconomic Scenario: Still on Track, but More Gradually* (February 14, 2020)
- *FX Compass – BRL: We Hope They'd Got It* (January 23, 2020)
- *Brazil Macro Propositions for 2020* (January 13, 2020)
- *Macroeconomic Scenario: A Better Outlook* (December 13, 2019)

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
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	598-1747-6805
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Luciano Sobral*	Senior Economist/Strategist – Brazil	lusobral@santander.com.br	5511-3012-6209
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			
Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Daniel Gewehr*	Head, Brazil	dhgewehr@santander.com.br	5511-3012-5787

Electronic	
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: Ana Paula Vescovi*.

*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
Corporate & Investment Banking