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BRAZIL – Credit Market

Will Rising Uncertainty Stop the Credit Recovery?

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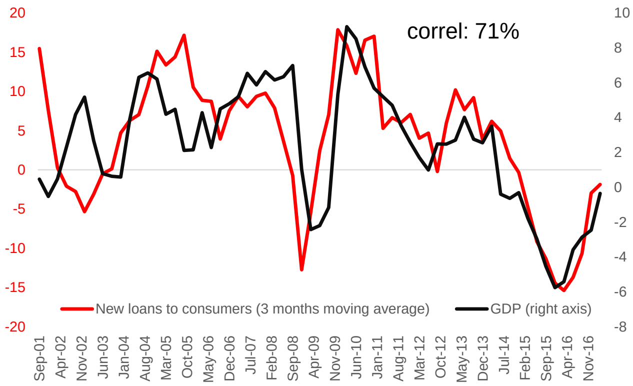
- **Credit data can be useful as an antecedent to economic activity recovery.**
- **In this sense, total outstanding loans are still declining for households and firms (y/y in nominal terms) but new loans are already showing some signs of recovery, especially for households (the focus of this piece).**
- **Looking ahead, the pace of the recovery in the credit market, and, consequently, in the real economy, depends on interest rates (final, for consumers and firms) and on the confidence rebuilding process. Indeed, according to our estimates, these two variables account for 80% of new loans movements.**
- **Considering our baseline scenario for the Selic rate and for delinquencies, we estimate that non-earmarked final interest rates to households will decline 10 p.p. by the end of 2017. Regarding confidence, it depends on the duration and intensity of the uncertainties that are embedded in the current domestic scenario.**
- **Adopting two different scenarios to the variables that explain confidence according to our models (CDS, BRL volatility, inflation and unemployment) we conclude that: (i) even with rising uncertainty the effect of falling interest rates should prevail, so, credit and GDP should still show a marked recovery; (ii) 2017 forecasts for both scenarios are similar, which means that the impact is concentrated in 2018; and (iii) for 2018, the impact should be around 140 basis points.**
- **Therefore, unless volatility shows a significant additional increase, we do not believe that the credit recovery (and its transmission to the real economy) will be halted.**
- **A potential adjustment to our forecasts depends on the duration of and the solution to the current low governability scenario, but financial market reactions suggest, so far, an intermediate scenario between the baseline and the stress scenarios.**

Last week we released a report analyzing what we consider important drivers for consumption, which, in our view, have not been receiving adequate attention from market analysts (see "*Understated Consumption Drivers*" published June 12, 2017). In this new piece, we take a closer look at one of these drivers: the credit market. Credit is showing some signs of recovery, but an important question at the moment is the potential impact of the higher instability derived from political uncertainties on the market, and, consequently, on economic activity. In order to measure this effect, we proceed in four steps: (i) we show that credit can be used as an antecedent to GDP growth; (ii) we identify the main credit drivers (as a spoiler, confidence and interest rates); (iii) we forecast the trend for these drivers, assuming different scenarios for financial market variables (which are drivers of confidence); and (iv) we estimate the impact of the different scenarios on GDP growth.

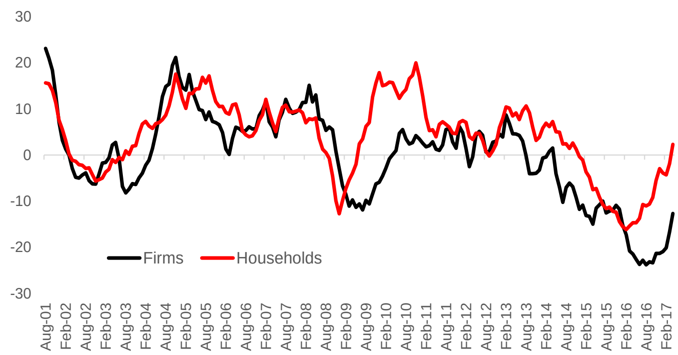
It is not difficult to see that the correlation between credit data and real economic indicators is high (71% considering new loans vs. GDP growth). However, high correlation does not necessary imply antecedent behavior. Thus, a necessary complement to showing that credit data can be useful for estimating the pace and time of the economic activity recovery, is verifying that credit leads GDP. An econometric test to perform this analysis is the Granger Causality Test. **We ran that test (using data from 2001 to 2017), and the result indicates that credit concessions Granger-cause GDP, but the opposite is not true**, which suggests that credit leads GDP. So, in the upcoming sections, we will analyze to what extent political instability affects new loans evolution, and, consequently, the pace of the economic activity recovery.

Figure 1 – Household new loans (non-earmarked) vs. GDP
y/y% (real terms)



Sources: BCB and Santander.

Figure 2 – New loans (non-earmarked): Firms vs. Households
daily average y/y% (real terms)

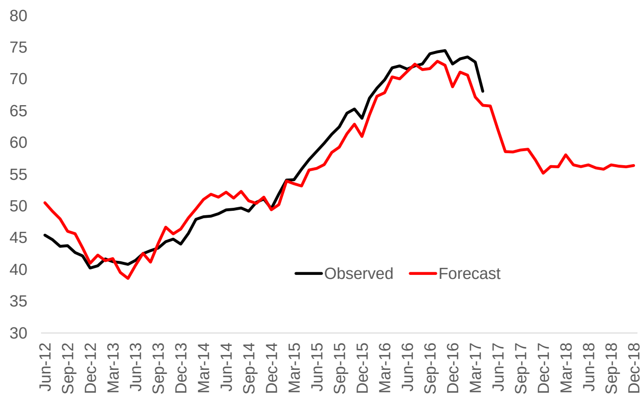


Source: BCB and Santander.

Currently, total credit outstanding is still decreasing, but new loans are already showing some signs of recovery, especially for consumers. Looking ahead, the pace of the recovery in the credit market, and, consequently, in the real economy, depends on two main drivers: (i) interest rates and (ii) confidence. Indeed, according to our models, these two variables account for 80% of new loans volatility – we tested other variables, such as total wages for instance, but they were statistically insignificant. As such, we conclude that forecasting or assuming hypotheses regarding these two metrics is necessary (and sufficient) for forecasting credit evolution. Regarding interest rates, it is important to note that, according to our models, final interest rates (for households and companies) are a better predictor of new loans than the Central Bank base rate, so, at this point, it is important to estimate a relationship between base rates and final rates (the difference between them is the spread).

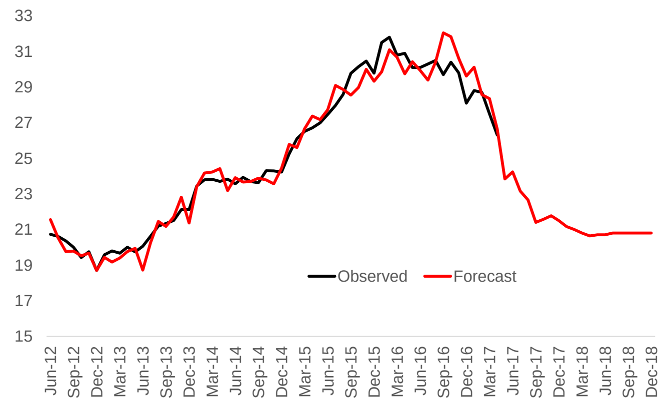
To do so, we derived an equation in which final interest rates are explained by the Selic rate and delinquencies. If our forecasts for both variables prove accurate – Selic at 8.5% by year-end, and non-performing loans stabilizing around 6% of total consumer loans and 5.4% of firm loans – final household interest rates would decline to somewhere close to 58% p.y., from 68% p.y. last April, and companies' interest rates would decrease to 21% p.y. (from 26%). **It is important to note that, according to our model, the decline in final rates would be stronger than for base rates, which means that the spread would decrease, as expected, since the historical pattern is a positive correlation between spreads and Selic.**

Figure 3 – Interest rates for households (non-earmarked)



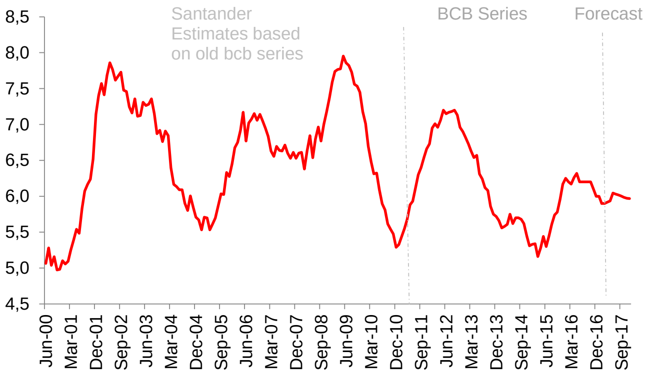
Sources: BCB and Santander.

Figure 4 – Interest rates for companies (non-earmarked)



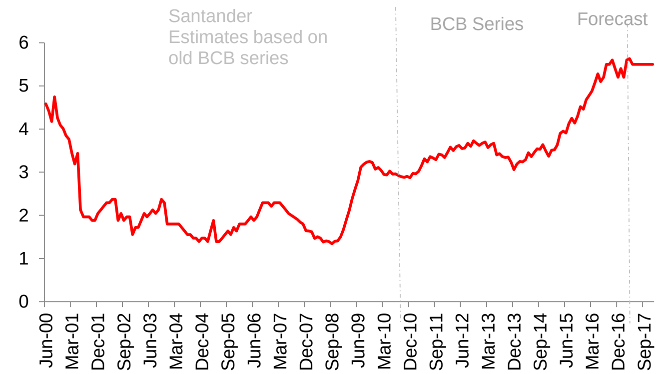
Source: BCB and Santander.

Figure 5 – Households' non-performing loans (non-earmarked)



Sources: BCB and Santander.

Figure 6 – Companies' non-performing loans (non-earmarked)

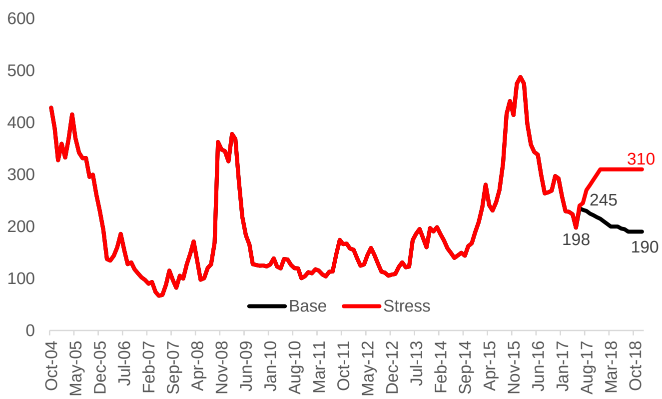


Source: BCB and Santander.

With respect to confidence, we have been observing a rebuilding process; however, the recent increase in uncertainty could interrupt the positive trend. In order to measure this effect and investigate potential future trends for this variable, we created a model with the following explanatory variables: (i) CPI inflation; (ii) the unemployment rate; (iii) sovereign CDS; and (iv) USD/BRL volatility (standard deviation of 90 days). Using this model, we created two different scenarios: **(i) base-case scenario:** CDS and BRL volatility gradually returning to the level observed before the increase of uncertainty, and unemployment decreasing at a gradual pace; **(ii) stress scenario:** CDS reaching 310 bps and USD/BRL volatility at the highest level observed this month until the end of 2018, and unemployment slightly increasing. For CPI we have used the same forecast for both scenarios.

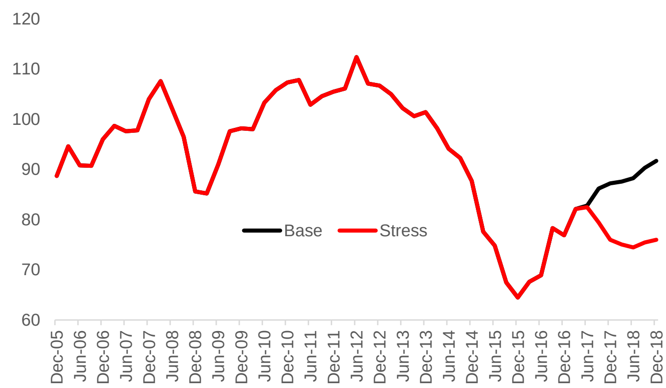
The result suggests that the stress scenario would be significantly worse than the base case, but deterioration in confidence would be limited compared to that registered in 2015 due to lower inflation and lower volatility than observed that year. This smaller increase in volatility (compared to 2015), in our view, makes sense, considering that fundamentals are much better now than two years ago (see our report "*Stayin' Alive*" published May 22, 2017).

Figure 7 – CDS Scenarios



Sources: Bloomberg and Santander.

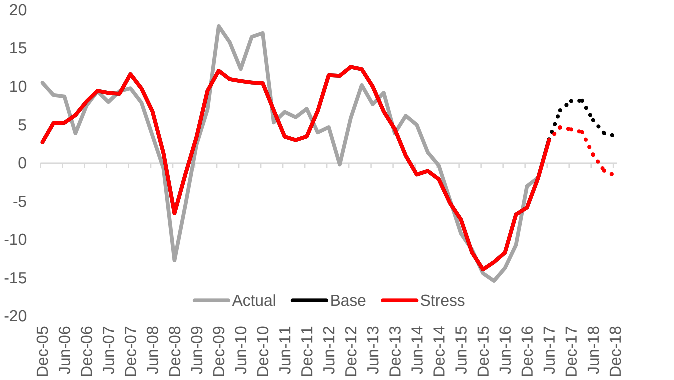
Figure 8 – Consumer Confidence Scenarios



Source: FGV and Santander.

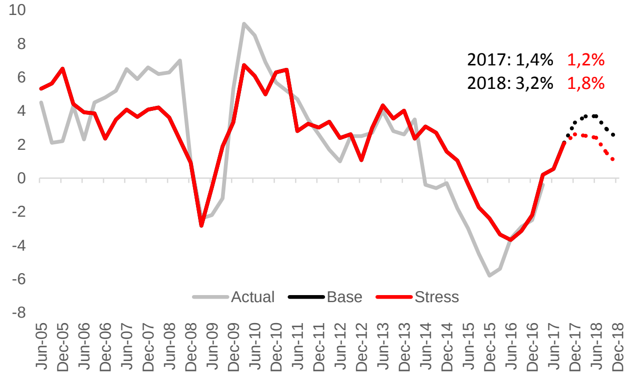
Finally, we can use our forecasts for final interest rates and the scenarios for confidence to generate scenarios for credit concessions and GDP growth. Comparing the resulting scenarios we conclude that: (i) even with rising uncertainty, the effect of decreasing interest rates should prevail, so, credit and GDP should show a marked recovery; (ii) 2017 forecasts for both scenarios are similar, which means that the impact is concentrated in 2018; (iii) for 2018, the impact would be around 140 basis points. It is important to note that this exercise only measures the potential impact of higher uncertainty through the credit channel, not changing our base-case scenario. **Our main GDP model is more complete and robust than the simple version used in this piece, but the results that we found here suggest that, so far, our base-case scenario (0.7% GDP growth for 2017 and 3.0% for 2018) does not seem excessively optimistic.** A possible adjustment to our forecasts depends on the duration of and the solution to the current low governability scenario, but financial market reactions suggest an intermediate scenario, between the base case and the stress case.

Figure 9 – New loans (non-earmarked) actual vs. scenarios



Sources: Bloomberg and Santander.

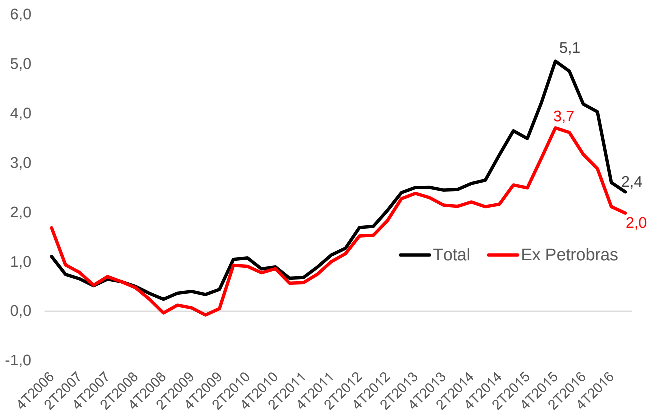
Figure 10 – GDP actual vs. scenarios



Source: IBGE and Santander.

This piece reinforces the important role of falling interest rates and its transmission, through the credit channel, to economic recovery. An important question related to this issue is whether the deleveraging process will limit this impact, especially in the corporate market. However, as we have been saying, firms' leverage indicators are highly cyclical and dependent on interest rates (see our report "*Will Deleveraging Limit Credit Growth?*" published February 3, 2017), so, with falling interest rates and the beginning of the cyclical recovery, companies' financial indicators should show significant improvement (a trend that is already underway).

Figure 11 – Debt / EBITDA



Sources: Economatica and Santander.

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