July 3, 2020

Latam Economic Update

- **Brazil: Industrial and manufacturing data provide further evidence activity bottomed in April**
- **Peru: Initial figures point to a 30% y/y decline in GDP in May**

BRAZIL: INDUSTRIAL AND MANUFACTURING DATA PROVIDE FURTHER EVIDENCE ACTIVITY BOTTOMED IN APRIL

On July 2nd, Brazil's industrial production for May printed almost on top of consensus (-21.9% y/y vs consensus 21.7%), and stronger than our expected -24.3% y/y (chart 1). More importantly, it rebounded strongly from the -27.2% y/y contraction we saw in April (on a m/m basis we saw a +7.0% print). The June print will be key to get a better idea of what Q2 GDP looks like. We already saw the manufacturing PMI for June print in expansion territory (51.6) which was materially stronger than we expected, in turn suggesting that the reopening of the economy proceeded better than we anticipated (chart 1, again).

At this point in time data seem to confirm our view that the worst of the pandemic for economic data is behind us, but a key question is how the sharply escalating contagion is Brazil will impact activity going forward. Over the month of June, Brazil became one of the top-2 COVID-19 hotspots globally, and the parabolic expansion of the number of cases could undermine the reopening (with or without a government lead). Our base case is we will see somewhat of a stop-and-go pattern for activity in Brazil until a medical breakthrough helps tame the risks of COVID-19. However, we expect future disruptions will be less severe than the first bout.

At first glance, looking at industrial production data by sector on a m/m basis (table 1), the strong bounces in "investment goods" suggest a rebound in confidence, despite the uncertain outlook for both activity due to COVID-19 and the worsening political climate (capital goods rebounded +28.7% m/m and durable goods +92.5% m/m). These bounces would seem to imply the underlying fundamentals for Brazilian growth are better than we anticipate. However, we think on this case, looking at data on a y/y basis is more illustrative, as it shows a more stable picture of how components have evolved during the political and health crises relative to 2019, and looking at it this way, the picture is less encouraging. Annual change data confirm our view that investment is likely to be the main drag on growth this year, and we don't anticipate that will change, unless political uncertainties are resolved and a major breakthrough is made in curbing the pandemic globally.

On the political front, the Brazilian lower house postponed regional elections by one month, with the first-round votes now scheduled for November 15th, and the run-offs for November 29th. Also, on the last day of Supreme Court sessions before the July recess, the investigations over fake news propagation by camps aligned with President Bolsonaro was extended for another 180 days, while investigations on alleged interference with police investigations which triggered Sergio Moro's resignation from the government was also extended

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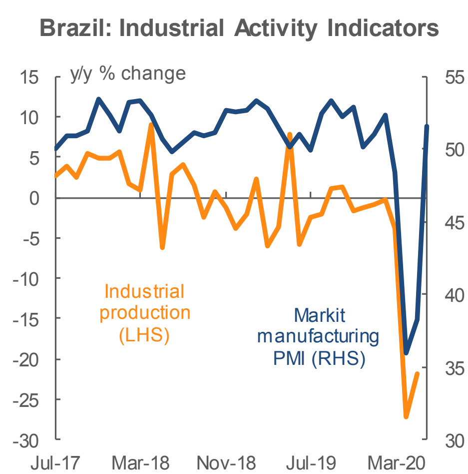
Chart 1



Sources: Scotiabank Economics, Bloomberg.

by 30 days, giving President Bolsonaro two adverse blows. We think that the combination of political and judicial uncertainty facing the Bolsonaro government, which continues to erode his political capital, mean hopes of further reforms are all but buried at this stage. In this complex political scenario, solving the country's complex fiscal problems seems like a challenge we won't see tackled in the current administration.

—Eduardo Suárez

Table 1

Brazil: May Industrial Production by Type of Goods

	m/m % change	y/y % change
Capital goods	28.7	-39.4
Intermediate goods	5.2	-14.6
Consumer goods	14.5	-31.0
Durable goods	92.5	-69.7
Semi/non-durable goods	8.4	-19.3

Source: Scotiabank Economics.

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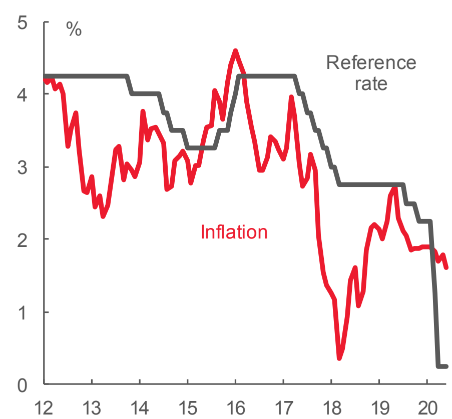
PERU: INITIAL FIGURES POINT TO A 30% Y/Y DECLINE IN GDP IN MAY

As the unlocking of the economy accelerates with Phase 3 on July 1, much of the data that is appearing continues to refer to the period when the lockdown was in greater force. The National Statistics Institute, INEI, released figures on growth in May for certain resource processing sectors. Fishing and mining came in below expectations. Fishing GDP declined 47% y/y. This decline was not surprising, given that the fishing season began late this year, but the magnitude was greater than the -25% we had expected. Fishing for fishmeal is not cause for too much concern, however, as the difference will be made up in June–July, when we expect to see strong double-digit growth in fishing GDP. What is more of a concern is how strongly non-fishmeal fishing fell, as both ports and restaurants demanding seafood, were closed.

The 49.9% y/y contraction in mining GDP was also significantly greater than the -35% y/y, that we were expecting. We had been under the impression that mining was operating at 65% of capacity in May. Possibly, this was a month-end figure rather than the average for the month, as mining companies needed more time to put health protocols properly in place. We continue to expect mining output to be back near normal levels by the end of July, but the process of getting there might be slower than we hoped for. Oil & gas GDP fell 21%, in line with our expectations. The northern oil pipeline was closed, but gas production in the south continued. The other data point we have for May is the 65% y/y decline in cement consumption. Construction unlocked on May 11 (thus the improvement over a 90% y/y decline in April), but there have been delays in putting health protocols in place in the private sector, and public sector investment continues to be absent. The upshot of this accumulation of information is that GDP will have contracted more in the range of 30% y/y, in May, than the -25% that we had been expecting.

Chart 2

Peru: Inflation and Reference Rate



Sources: Scotiabank Economics, BCRP.

Meanwhile, public investment plunged 72% y/y, in June, according to preliminary figures obtained by the local press. This is nearly the same as the -73% y/y in May. As such, it is tremendously disappointing, since Phase 2 of unlocking was in full force in June, and there is little reason, outside of overbureaucratic lethargy, for the government not moving forward, faster. The risk is that State investment execution becomes the main force in delaying the economic recovery. Note that, given the decline in June, public investment will have fallen 34% y/y, in the first half of 2020. Thus, the government's goal of 1% growth for the full year seems hugely optimistic.

Inflation for June came in at -0.27% m/m, taking the yearly figure to 1.6%. The negative monthly figure was a mild surprise, we were expecting nil. However, the trend is very much in line with our expectations of 1.1% inflation for the full year. The new figures do not change our expectation that the BCRP will leave its reference rate unchanged at 0.25% next week (chart 2).

—Guillermo Arbe