Sector performance amid the COVID-19 pandemic

Measures to combat the COVID-19 pandemic have changed the outlook for individual industries differently. Social distancing brought Brazil's economy to a halt as investment and household consumption, which were expected to sustain economic growth, will be hit hardest. The government announced emergency measures aimed at supporting income and employment, providing financial liquidity and fighting the virus, which will lead to an increase in the fiscal deficit levels and, consequently, a rise in gross debt. Combined with a high level of uncertainty, fiscal deterioration has led to a risk rating downgrade and currency depreciation. Even so, consumer inflation has been well behaved, allowing for two policy rate cuts during the pandemic and bringing the Selic rate down to 3% p.a.

The 5.9% contraction of GDP for this year will be driven by the service and manufacturing sectors. Service GDP (including commerce) is expected to decline by 6.0%. Passenger transport, tourism and leisure are likely to suffer more than other sectors. Retail also experienced a sharp decline during the quarantine period, driven by car sales. Manufacturing will also see a significant decline, shrinking 7.5%. The biggest impact will be in capital goods, given the high degree of economic uncertainty.

Few sectors will experience positive demand in this environment. Demand will remain positive for agriculture, which is expected to grow 2.0% in 2020. Supermarket sales will also continue their positive trend. Pharmacy sales are also expected to grow this year once the economy reopens. The changes needed to promote social distancing have been a boon to e-commerce, deliveries and IT services.

Chart 1: Economic activity indicators
Jan-14 =100

Source: IBGE

Hardest-hit sectors

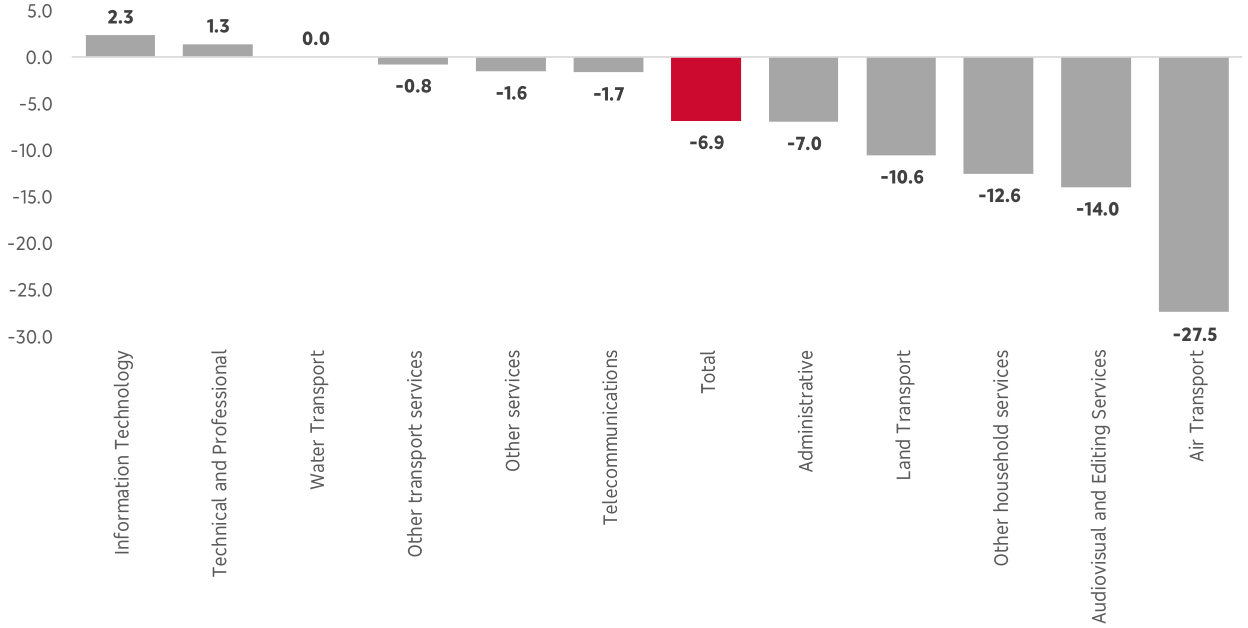
The service sector has been hurt the worse by the crisis. Especially those that rely on close physical proximity, such as aviation, tourism, recreation, passenger transport and household services (Chart 2). Demand for these services fell 70%-90% during the lockdown. The impact has been so significant that the federal government has taken steps to support the tourism and air travel industries, such as: i) assuring travelers the right to seek reimbursement or reschedule their reservations to within 12 months; ii) creating a minimum essential air service program; and iii) postponing concession auctions for 6 airports, from May to December (Confins, Galeão, Fortaleza, Salvador, Florianópolis and Porto Alegre).

Not only will these sectors be affected during social distancing, but will also see a more gradual recovery. China's reopening experience can provide some valuable lessons, since 90 days have elapsed since the country restarted activities. At the end of April, tourism sector demand was at 40% of normal; for aviation, around 30%; and for restaurants, between 30 and 50%. People are still concerned about contracting the virus even with the new rules of engagement (masks, distancing, sanitizing).

In commerce, the durable goods, clothing and footwear segments will see sharper declines. The numbers for March have already shown a major drop for these non-essential segments (Chart 4). Traditionally, durable goods, clothing and footwear suffer the most in times of uncertainty and loss of income. The current crisis will be no different. Shopping malls, which traditionally have a significant stores leased to clothing and footwear retailers and restaurants, will likely take longer than general retail to return to normal. Again, in China, demand for shopping malls is at 60% of normal even after more than two months of reopening.

Título do Gráfico

Chart 2: Service sector revenues (nominal)
Percentage change in revenues, Mar-20 vs. Feb/20, not seasonally adjusted



Source: IBGE

Capital goods and automobile manufacturing will fall sharply in 2020. The factors for such decline include a high level of uncertainty and an expected drop in household income and business revenues. Companies will reassess their investment plans, and most will end up postponing these decisions. On the household side, there will be less consumption of non-essential products, especially high added-value goods. Low interest rates will likely minimize the negative impact, but won't be enough to offset the negative performance for the year.

The oil industry has been impacted on a global scale. The recession caused by COVID-19 significantly reduced global demand forecasts for oil and gas. The supply cuts agreed between OPEC and its allies, however, will not make up for the lost demand, which has led Saudi Arabia to make additional output cuts. Oversupply has led to falling international prices. In Brazil, we were already expecting a drop in production (before the crisis), but low prices and even lower domestic demand are likely to hurt the sector. The same is true for ethanol. The drop in consumption and price competition with gasoline led to a sharp reduction in ethanol production.

Medium-impact sectors

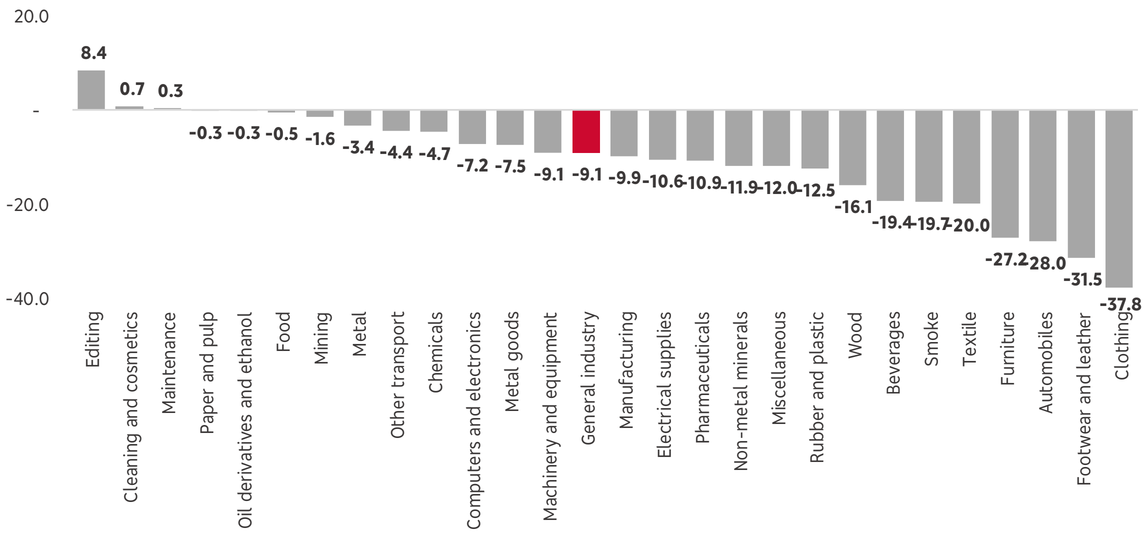
The electricity, telecommunications and education sectors are expected to grow in line with GDP. Power generation fell approximately 15% during the shutdown. The free energy market (large customers) has seen an even bigger decline, at close to 30%. With the end of social distancing, we expect electricity consumption to bounce back, especially for large customers. The National Electricity Agency (ANEEL) allowed no-contact meter reading and suspended disconnection for unpaid bills. Electric companies can also take out loans to postpone rate hikes. In telecommunications, data usage rose by approximately 30%, as the pandemic drove up remote work and shut down school buildings. In general, carriers increased the download and speed limits and have guaranteed the expansion and maintenance of their network infrastructures. On the other hand, there was a decline in prepaid mobile recharges, which makes up a significant share of telecom revenues.

With in-person classes suspended, officials had to make emergency plans to transition to remote education. As a strategy, primary schools shuffled their calendars to move forward vacation breaks and launch remote learning within 30 days. Universities and colleges followed suit. Unlike the traditional distance learning method, in which students can contact tutors for help, the teaching method used during the pandemic is an online version of in-person classes. While distance learning has gained widespread popularity for adult education, some question its efficacy on children. As it stands, teachers and students face major roadblocks such as the lack of equipment, ad especially at public schools. However, these measures are temporary, and it is expected that children will soon be heading back to the classroom. Online learning will continue to become increasingly prevalent in higher education. The barriers to distance learning have certainly been lowered. Second semester enrollment numbers will definitely be much different than normal, and the loss of income/employment will put a strain on family budgets. Concerns for these basic services are associated with an increase in unemployment and a decrease in family income, which can lead to nonpayment or even service cancellation.

Production for the steel and chemical industries is expected to match the average for Brazil's economy. The steel industry suffered a negative impact from the auto manufacturing shutdown, reduced external demand and, to a lesser extent, a drop in demand from construction companies. With reduced demand, steelmakers decided to idle blast furnaces in April. Some units cranked back up in May while others are set for a return in June, as automakers resume steel purchases. The demand for long steel hasn't fallen much since construction sites have not been forced to close, but a decrease in new starts will likely postpone recovery for this segment.

The chemical industry can increase its share in the Brazilian economy. The sector is inserted in practically every supply chain, and therefore stands to benefit from an increased use of chemical products by the personal care, pharmaceutical and food industries. On the other hand, there is a negative impact due to falling demand from the automotive and construction industries. It is important to note that the price of chemicals is pegged to the U.S. dollar and that this has driven up the price of inputs, as shown in the wholesale inflation data.

Chart 3: Manufacturing output by sector
Percentage change in output, Mar-20 vs. Feb-20, not seasonally adjusted



Source: IBGE

Positive trend continues for Chinese demand for iron ore and pulp. China's reopening of infrastructure activities helped boost iron ore exports. It is important to remember that the Brazil's supply remains limited due to the accident in Brumadinho and production will take some time to recover to 2018 levels. International prices are still at high levels, which, combined with a depreciated exchange rate, guarantees good margins for exports. But Chinese demand for pulp remains low, with international prices down. Even so, the external channel is outperforming the domestic channel, which has been negatively impacted by the demand for paper (although tissue paper sales continue to trend upwards).

Labeled an essential activity, ongoing construction sites were not shut down. However, new construction projects were not allowed to start. For the real estate industry, the prospects of lost income and jobs will likely hold back growth in the months ahead. In this sense, the sector has made efforts to expand its online sales platforms, but even the low interest rates will not make up for the loss of income. Commercial real estate has seen vacancies rise and should recover gradually, eventually undergoing structural changes caused by the shift to remote work. The demand for logistics warehouses will continue to benefit from the growth in e-commerce. In infrastructure, there are concerns with the economic and financial rebalancing of current concessions (as mentioned above, airport concessions have already been postponed). Most concessions planned for 2020 were scheduled for the second semester, and that schedule is still in place at this moment. Except for airport concessions, which have already been postponed to 2021 by the Ministry of Infrastructure. The projects continue to move forward, with a public tender being issued for port areas, while others are under review by the Federal Court of Accounts or under public consultation, but some will be pushed back to next year. In addition, investor interest remains high in projects such as highways and railways designed to move agricultural goods out to ports.

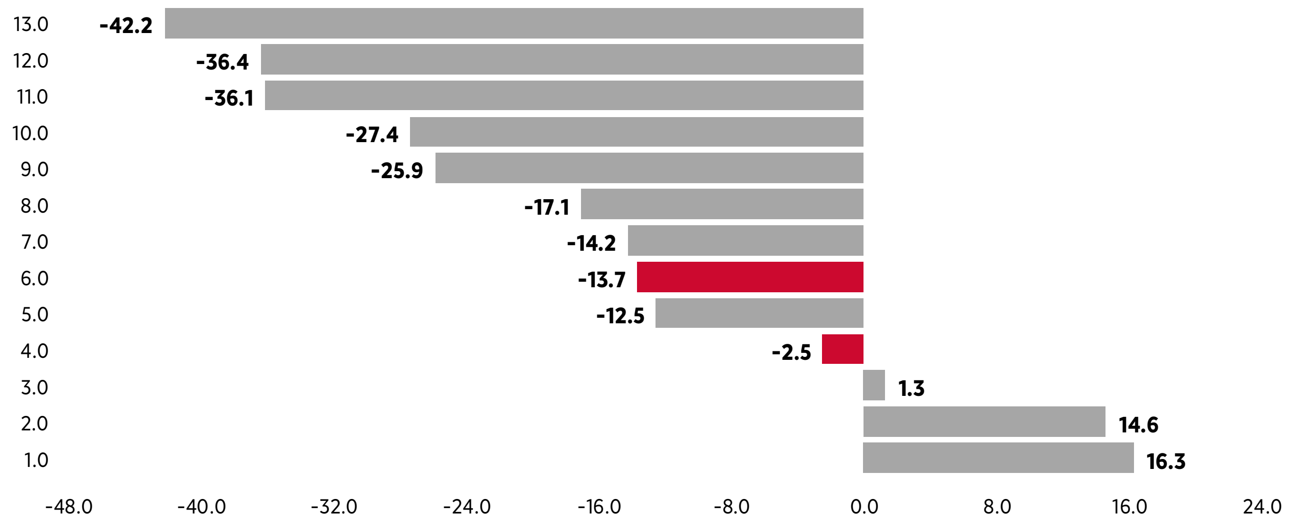
Low-impact sectors

Essential goods, in turn, are resilient in times of crisis. Food and medicine are at the top of that list. In this sense, the agribusiness and pharmaceutical industries and their respective distribution channels – i.e., supermarkets and pharmacies – have been the least impacted by COVID-19.

With rare exceptions, agribusiness will continue to see a positive demand trend this year. Global demand for food is expected to decline, with food service being replaced by food at home. However, it will suffer less of a blow than other sectors. Therefore, global demand for agricultural commodities remains high and our exports hit record levels at the beginning of the year. International grain prices fell, but a devalued BRL helps drive up exporters' margins and keeps domestic prices high, even in times of weak domestic demand. Amid this scenario, consumers have prioritized staple foods. There were significant drips in chicken and pork prices, putting pressure on farmers' profit margins. Demand for sugar and coffee could also suffer a blow this year due to the loss of income, but external demand for these goods remains positive and generates good profits for farmers.

Supermarket sales have remained on a positive trend during the shutdown. The segment has seen accelerated growth since social distancing measures were announced. At first, there was a rush to stockpile food products. A few weeks after the start of social distancing, supermarket demand flattened out at a high level, reflecting the shift in consumption from restaurants to food at home. This behavior is likely to persist even as social distancing is relaxed, keep supermarket sales on a positive trend throughout 2020.

Chart 4: Retail sales volume
Percentage change in sales, Mar-20 vs. Feb-20, not seasonally adjusted



Source: IBGE

The pharmaceutical industry is also likely to see just limited impact from the crisis. So far, drug sales are up when compared to last year. However, after consumers rushed to pharmacies to stockpile medications in March, drug sales lost momentum in April. It is important to note that sales are increasingly shifting to e-commerce, whether via in-house or third-party channels. Demand for long-term medication remains positive and there has been an increase in demand for drugs associated with COVID-19. On the other hand, doctors' visits are down and surgeries and procedures have been postponed, with a consequent reduction in the number of medical prescriptions and consumption of other drugs. Telemedicine has grown quickly during the quarantine period, but has not fully replaced demand for traditional consultation. Going forward, demand for medicine is likely to stabilize on a positive level, but the loss of income should lead to underwhelming growth for 2020 and 2021, with generic drugs increasing their market share.

The digital world is becoming increasingly prominent. Barriers to e-commerce and teleconferencing were lowered during social distancing. Thus, e-commerce, remote work and distance learning are set for significant growth even after the reopening of activities. An FGV study shows that remote work will grow as much as 30% after Brazil reopens its economy. This new pattern of behavior drives the digitization of all processes, including digital contract signing, and requires increased data security. E-commerce, which has been growing substantially in recent years, is expected to reach maturity in Brazil with the increase in online purchases for perishable goods and clothing. In the same sense, the use of video conferencing technology will continue to expand, especially for distance learning in higher education. In medicine, the permission to provide teleconsultation is only valid during the state of emergency – in other words, advances in telemedicine in the post-crisis period will require legislative changes.

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