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Brazil: Binary, Bumpy, Buy?

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Executive Summary

Portfolio Manager Eric Fine recently spent a week in Brazil, meeting government and opposition economic and political experts, as well as independent analysts and local market participants. Politics were a key focus, given October presidential and legislative elections and the very divergent policy agendas of the main parties in an economy that has a large fiscal deficit, and a world that is less willing to provide finance. The attempted assassination of the country's leading presidential candidate took place during the trip, so its implications are also considered.

Binary Economy

- Economic outcomes are binary. Brazil's economic outcomes will largely be a function of the policy choices made following October's elections. If the stated policy prescriptions of the main political forces are to be taken seriously (i.e., limited social security and other reform from left-wing parties, serious social security and other reform from right-wing parties), Brazil will either face a fiscal and economic crisis, or an economic boom based on confidence that long-term fiscal (and other) issues are addressed.

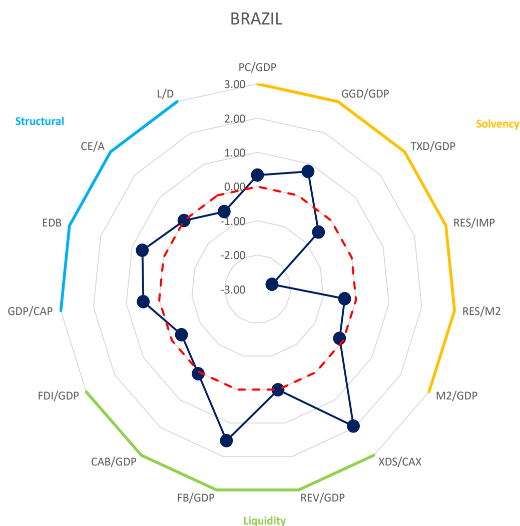
- Brazil has plenty of U.S. dollars. Since market lore has it that only dollar shortages create crises (we disagree, but the shortage of dollars has for sure made Turkey and Argentina more acute problems), let's acknowledge a key strength of the Brazilian economy. The stock and flow of dollars is very strong. Reserves, at around $370bn, are high relative to external debt, imports, and even central bank liabilities (known to mortals as money—Brazilian real held by the population in cash or banked forms).

- And the flow of dollars is good…unless confidence falters after elections. The country's current account deficit is small at 1% of GDP, more than financed by FDI (foreign direct investment). The risk to Brazil's external position, though, comes from a scenario in which locals lose confidence and exit domestic currency holdings in a capital flight. This scenario quickly becomes self-fulfilling as a weaker currency confirms ever-rising inflation expectations, and the collapse in confidence undermines growth. A fiscal crisis ensues, in this scenario. We see this is as a real possibility following October elections in the event of a victory by some of the main market-unfriendly candidates for president.

- Inflation outcomes could be extreme in an adverse election scenario. T-he binary political and policy outcomes we reference above will have the same impact on inflation (now trailing at 4.2%), and inflation expectations (now at 4.1%), in our view. Brazilian citizens have been through it all, and they are experts in what to do in runaway inflation (buy USD), in our opinion. We need to say this because many officials argued that Brazilian behavior has changed and that capital controls are effective, etc. We completely disagree. In an adverse political/policy scenario, we see an immediate increase in inflation and inflation expectations, as a "fiscal dominance" (i.e., "You are spending so much in your budget, monetary and other policies are irrelevant!") takes hold. We believe the central bank would be forced to hike rates on a government that has high debt and deficits, or tolerate runaway inflation if it doesn't. No good outcomes, in other words, and the population buys dollars with little sensitivity to price. We would note that Brazil currently has among the lowest real interest rates (at around 230bps—the policy rate is 6.5% and inflation is trailing at 4.2%) it has had in its recent history, so the scenario we describe has no cushion in our view. Oh, and headline inflation was over 10% (!!) just over two years ago(!). So rein it in.

- Inflation should be anchored in a positive election scenario. Capacity in the economy is high, unemployment is high, the country is exiting its worst depression in over 100 years, and, so far, inflation and inflation expectations have been well behaved. In an election scenario in which an orthodox economic program is implemented, we expect this to continue. In fact, the Brazilian real's strength could be so significant we'd expect another leg lower in inflation and inflation expectations and further scope for central bank interest rate cuts. These would likely reinforce any reform agenda from the new political authority. In any case, we hope that our sense of the binary nature of outcomes is reinforced, which is our main point.

- Our "radar chart" (below) for Brazil shows how our investment process highlights these economic positives and negatives. The fiscal deficit (FB/GDP) is very high—almost 2 standard deviations worse than the global average. General government debt is high (GGD/GDP). As a result, we believe they must be addressed by policy. This is not a country that can afford "sideways". We also show, however, that reserves are high (RES/M2, or RES/IMP), also consistent with our view that the economy has key strengths as well.



Note on radar charts: The red circle in the chart above is the mean for each radial (each radial measures an important variable such as PC/GDP, or private credit as a percent of GDP, etc.). The dark line is the result for Brazil, with results outside the circle being worse than the mean, and results inside the circle being better than the mean. Please see footnote located at the end for description of metrics.

Binary Politics

- It is all about the politics. There are clearly more complexities to the election than who wins. Coalitions, policy compromises, or complete policy turnarounds in the face of economic adversity are all part of this story. Nonetheless, the key market focus right now remains on the presidential elections. There's a first round on October 7, which you can think of as a kind of combined primary election in which leading left- and right-wing candidates are chosen. Then there's a runoff between the top two on October 28 (most likely between a leading left- and right-candidate). Most we met with agreed that the outcome of elections would drive economics and asset prices. The country can't keep spending and borrowing as it is, so a policy response will be demanded one way, or another.

- Every candidate pays lip service to some social security reform. There is some understanding that the budget math will not add up, and soon (2019, maybe 2020, sees constitutionally-mandated cuts in spending, if deficits are transcended). Candidates and parties tend to be vague and there's obviously risk of dissonance between pre- and post-election rhetoric. Many pointed to the lip service all are giving to social security reform as comforting—"They all know they need to do something". This is possible. Color us cynical! We believe that a minimum requirement for such a 180-degree policy turnaround that means real pain for voters in a fractured political environment is an economic challenge. Put differently, we can envision a market-unfriendly candidate completely turning his or her ideology around. But not just because it is the logical thing to do or because it will prevent a theoretical crisis. We see this only occurring in the event of it being forced: by the market and/or economy, and not because it'll be doing great. That's our view.

- Bolsonaro is consolidating the right. Following an assassination attempt, presidential candidate Jair Bolsonaro is rising among right-wing voters, making him the likely market-friendly candidate in the second round. The entire strategy of the other market-friendly candidate, Geraldo Alckmin, was to attack Bolsonaro in the first round to become the leading right-wing candidate. The assassination attempt seems to have quashed that strategy.

- Bolsonaro's economic program appears extremely pro-market to us, but not completely so to the market. We spent a lot of time examining policy details from this candidate. They appear radically reformist, in our opinion, as well as pragmatic. Most

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important, there is support for immediate approval of the current social security reform program that is sitting in Congress. Such approval could happen before a "President Bolsonaro" is inaugurated. We emphasize this because there have been alternative, more radical, social security reforms that they've proposed, and some worry that this will bog the reform progress down. In our opinion, the current social security reform program will be approved and deeper reforms that are being mooted will enter the agenda but won't freeze it. The rest of the reform program is stunning, including calls for privatization. We won't get into the details, and would note that there are limits to what candidates say before elections, but we are very hopeful on initial policy in the event of a Bolsonaro victory.

- The risks with Bolsonaro are whether he can get legislation through Congress, and perhaps his true commitment to reform. Bolsonaro has been in Congress for almost three decades and has no real coalitions nor policy legacy. He seems to have few long-term advisers or friends outside his family. His negative rating in polling is extremely high at 40%-ish. Trust in the political system is low. While his economic policies sound great, he's never had them tested and many of them are recent. His comments on non-economic topics will get a lot of attention, too (we only opine on economically-relevant topics). These are all legitimate risks, in our opinion. Nonetheless, we'd say the following. First, if he wins, the first 100 days will likely be dominated by a market-friendly narrative, regardless of what eventually ensues; talk to us then. Second, presidents can now essentially tailor budget cuts when spending caps come into force (likely in the next year or two), so you want the president on your side if you are in the legislature. Third, we believe that the country's corruption scandal has created a window to "move ahead", and positive policy progress could shield some from ongoing judicial pressure.

- Another risk with Bolsonaro is that he loses in all the second-round election scenarios, according to leading pollsters. Jair Bolsonaro loses against all of the main left-wing candidates. In some instances, he is crushed. The left's best chances against him are Marina Silva or Ciro Gomes. The market may buy a muddle-through scenario on Marina, as she's vague and muddle-y policy-wise. Ciro, though, is outspoken and recently randomly promised voters to eliminate adverse credit scores, for example. Bolsonaro comes closest to winning a second round when he runs against the PT (the "workers party" of former president Lula) candidate Fernando Haddad. Haddad may be the likeliest left-winger to make it into the second round.

- The two most market-unfriendly left-wingers are likely to rise going into the second round election. Ciro Gomes' numbers are rising, as are those of PT-sponsored Fernando Haddad. Market fear of Ciro is based on his ideology and erratic style. We believe market fear of Haddad is not based on him personally. He is considered to be pragmatic and logical. The issue is his party and whether he can shepherd it through economic challenges by doing the exact opposite of what it wants, all while basically working for former president Lula, who will be calling many shots. Haddad, too, has very high negative ratings (second only to Bolsonaro).

- The politics are fractious. Note that what we've basically said so far is that Brazil's next president will be one of the two candidates with the highest negative ratings among the population (Bolsonaro or Haddad).

- Brazil's politics are similar to planet Earth's. The political discussion was stark in its parallels with other countries'. Media distrust is high, at north of 80%. Female voters report Bolsonaro intentions anonymously but not in public Anger is a big driver of intentions. Crime is a rising issue. Poorer voters are considering an anti-crime right-winger. The country's most popular politician (Lula) is in jail and is endorsing the country's second-most disliked candidate (Haddad). There will be a lot of pixels devoted to this.

Investment Implications

- So what? OK, we've just told you it's a binary outcome for asset prices. They either go up a lot, or down a lot. It depends on an election. What do we do with this situation?

- We still really like Brazilian corporates…which is not the same as liking the Brazilian "sovereign". The advantage of a blend approach (that can invest in sovereigns, corporates, local currency, and hard currency) is that one doesn't have to have a "monolithic" view on Brazil. Here we favor corporates, especially those that sell to a booming U.S. market in dollars and whose expenses are mostly in local currency, so they've benefited from currency weakness and U.S. strength, and been largely unaffected by Brazilian developments. One could even argue that those corporate exposures show how cautious we are on Brazil.

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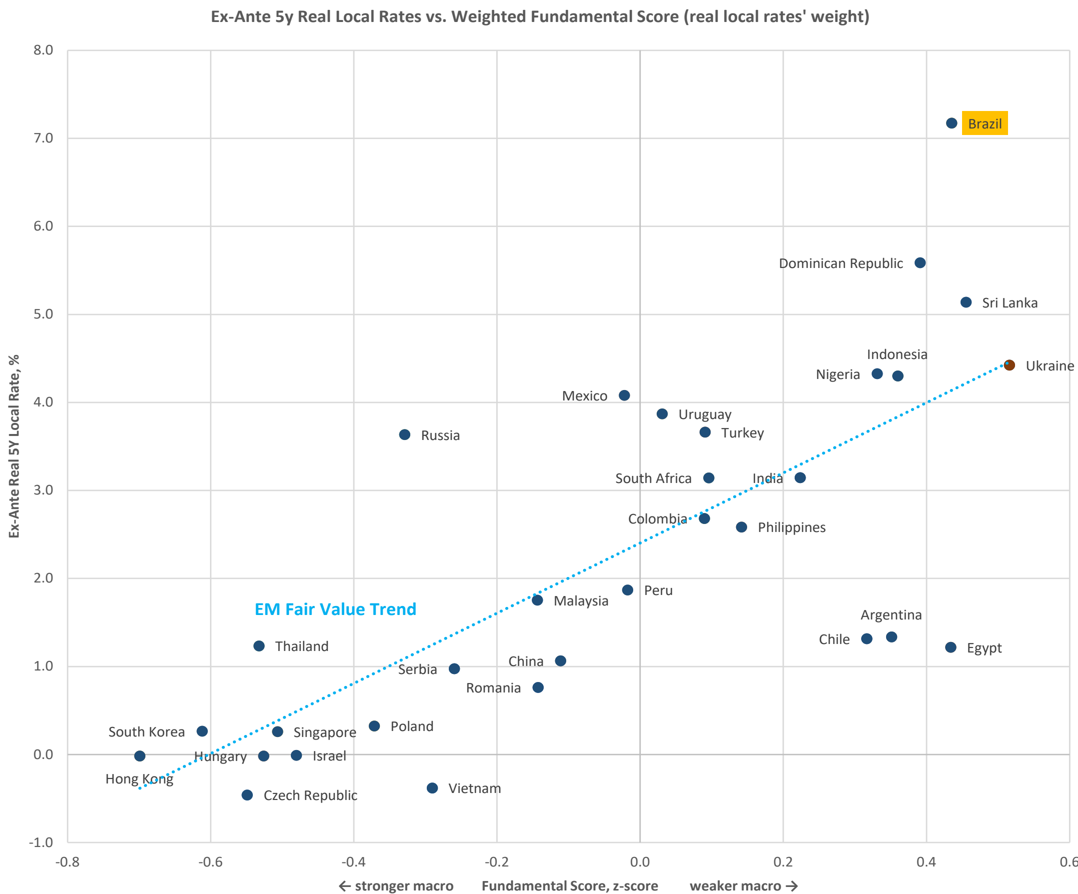
- Open-minded and nimble on the sovereign in local currency and in dollars. These markets are much tougher calls, given the arguments above. What we think following our trip is that it is harder to justify low exposure in sovereign, whether in hard or local currency, given the boost candidate Bolsonaro is likely to receive following the assassination attempt.

- Conviction is low, positions are light. We were also struck by how light positioning was in general, domestically, and how common long USD/BRL positions were, which would obviously get profoundly challenged if Bolsonaro's numbers start to rise. More specifically, we are open to being less underweight than we are, and will be watching developments that either encourage or discourage our warming up to Brazil. In hard currency, state-owned Petrobras would be our likelier expression of lower bearishness, as the spread is so much higher than the pure sovereign.

- Our valuation process shows how cheap Brazilian local currency is, and thus how dependent it is on passing the "Testing" phase of our investment process. Brazil pays high real interest rates relative to its fundamentals, as seen in the graph from our investment process below (which compares the "premium" defined as real interest rate on the y-axis, to "fundamentals" defined as the "radar chart" overall score on the x-axis). This gives it a large initially recommended allocation in our investment process, prior to the Test step. Brazil starts out looking "cheap", despite its weak fundamentals.

- Allocations to Brazil are constrained because it fails some of the three Tests in our investment process. After finding bonds that are cheap relative to their fundamentals, our process invokes three Tests – Policy/Politics, Economic, and Technical. Because of our discussion above, our Policy/Politics test result is still negative, just less so after our visit. The Economic test score remains negative due to the country's vulnerability to policy mistakes, as well as an unforgiving global financing environment. The Technical test score is slightly positive, actually,



as locals appear long USD to us, and many do not expect a Bolsonaro victory to generate market-friendly policy.

- The overall picture, thus, is of something that is cheap, but has some good reasons to be. As a result, we will modulate exposures to local currency with the ongoing political process. If we see reasons to improve test scores, our exposure should increase. If we see the opposite, we should remain fairly underweight.
- And we haven't invoked the global scenario (everything from trade war with China to U.S. interest rates), about which we are nervous, which is clearly adverse for Brazil. This paper is about Brazil. But it exists in a world which we'd describe as less and less friendly for countries with Brazil's initial conditions. Any global trade conflict that China allowed to weaken its currency (and why would it want to bear the brunt of any adjustment, alone among emerging economies?) would feed immediately into Brazil via its currency, given the importance of metals exports to China, in particular. Similarly, a Fed that keeps hiking does increase demand for dollars, all else equal. A number of large local financial participants said the only asset they could make a case for was two-year U.S. Treasuries. These sorts of risks would also feed through our Tests and could be adverse.

Radar Chart Key - PC/GDP - privatte credit to GDP, GGD/GDP - general government debt to GDP, TXD/GDP - total external debt to GDP, RES/M - international reserves to months of imports, RES/M2 - International reserves to % M2, M2/GDP - M2 to GDP, GR/GDP - Government revenue to % GDP, FB/GDP - Headline fiscal balance to % GDP, CAB/GDP - Current account balance to % GDP, FDI/GDP - Net FDI to % GDP, GDP/CPT - US$ GDP per capita to PPP, EDB - Ease of doing business, CE/A - Common equity to % assets, L/D - Loans to deposits ratio, XDS/CAX - External debt service (public and private) to % CA receipts.

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