Fundamental Fixed Income

Market update: Brazil – a conundrum for investors

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Brazil's corruption-shocked economy has become accustomed to political instability since the re-election, and subsequent impeachment, of then President Dilma a little over three years ago. Indeed, politics surrounding fiscal reforms were at the heart of Standard & Poor's decision to downgrade the nation from BB to BB- earlier this year.

Unfortunately, October's presidential elections (first round 7 October, second round 28 October) appear unlikely to reduce this uncertainty in 2018, given that:

1. Dilma's successor and current President Michel Temer is almost certain to not run, as his approval ratings are very low, and
2. Poll leader and former President Lula Da Silva looks increasingly unlikely to receive clearance to run after having his corruption conviction upheld

We believe a political vacuum that sucks in an extremist leader is a distinct possibility, and that such an outcome threatens to exacerbate concerns around Brazil's fragile fiscal profile.

Politics and current affairs – 2018 likely to be a difficult year

A brief analysis of President Temer's tenure explains his dismal approval ratings. Temer has faced multiple corruption accusations during his presidency, although it is also important to note that he has not had anything proven against him relating to such allegations. Furthermore, without the restriction of vote-seeking for re-election, Temer's government has looked to push through a series of controversial policies. These include amendments to the criteria under which worker treatment constitutes slavery – an initiative which has been met with concern domestically, as well as internationally by the UN. Another more current example is Temer's push for harsh social security reforms, which he claims to be vital to fight the deficit and protect future pension payments, but which critics argue would have a disproportional impact on lower income workers and those in more physically demanding work.

Consequently, we find ourselves questioning who will emerge as Brazil's new President in the coming months. However, in line with Brazil's recent political history, the answer is convoluted.

Former President Lula leads polls with around 34%-37% of voters' first round intentions, but as his corruption conviction was recently upheld unanimously by an appeals court, the legality of his candidacy is looking increasing delicate. Lula can ask for clarification about the decision and then appeal to the Superior Courts. If that happens, Lula's Workers' Party is likely to continue campaigning behind him, which further complicates matters as they cannot put any other candidate forward at the same time. Candidates need to be registered by the electoral court by 15 August, but can be replaced by their party up to 20 days before the election, making the whole process even less predictable. However, officials in government (i.e. the finance minister and the party's potential running replacement Henrique Meirelles) have to step down from their office by 7 April to be eligible as candidates. Whilst in theory Lula can even run if he is a prisoner and subsequently have his candidacy invalidated, we consider such a scenario to be unlikely. As such, we have to consider polls without front-runner Lula.

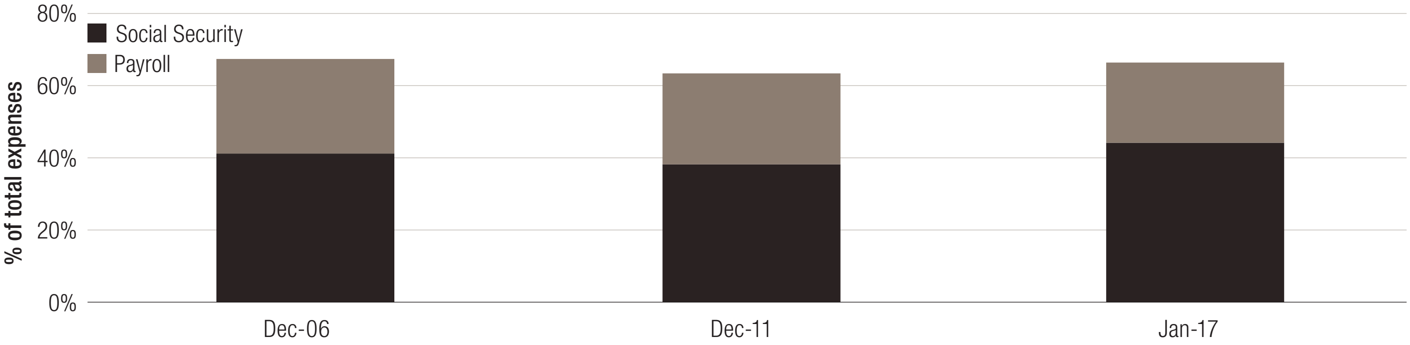
As a direct result of Lula's likely absence from the race, many leftist candidates are beginning to emerge – at least half a dozen, in fact; more than double the number running in the 2014 election. The consequence is that the dispersion of votes on the left has given rise to Jair Bolsonaro, a former military officer and right-wing populist, who leads first round voting without Lula with around 18%-20% backing. However, due to the two round nature of the system, leftist candidate Marina Silva of REDE (Green Party) and market-friendly Geraldo Alckmin from PSDB (Social Democracy party) look likely to defeat Bolsonaro in the second round. Another left wing candidate to look out for is Ciro Gomes of the populist PDT (Democratic Labour Party), who actually polls tightly with Alckmin in first round intentions.

Essentially, if only one extremist candidate proceeds to the second round, a more centrist candidate would likely defeat them, yet a high-risk scenario certainly exists whereby both populists could pass to round two, similar to the feared outcome in the French elections last year. It is, however, vital to stress the uncertainty that still surrounds this due to Lula's positon, with over 30% of declared Lula voters stating that they are either undecided or would annul in the event that he does not run.

Key worry – fiscal position and the unresolved structural reforms

A consistent theme in Brazil's long running political circus has been the economy's weak fiscal position that the government has failed to address sufficiently for many years now. Although one of Temer's few political victories during his troubled tenure was the approval of a cap – at the level of inflation – on spending increases for the next 20 years, any additional meaningful reforms have struggled to achieve a political majority. The key issue is that mandatory spending (salaries, pensions etc.) accounts for around two thirds of total government receipts (Figure 1), and has been at this level for over a decade now, which substantially constrains the government's scope for adjustment without creating additional political pressure.

Figure 1 – Brazil-government expense breakdown



Source: Bloomberg.

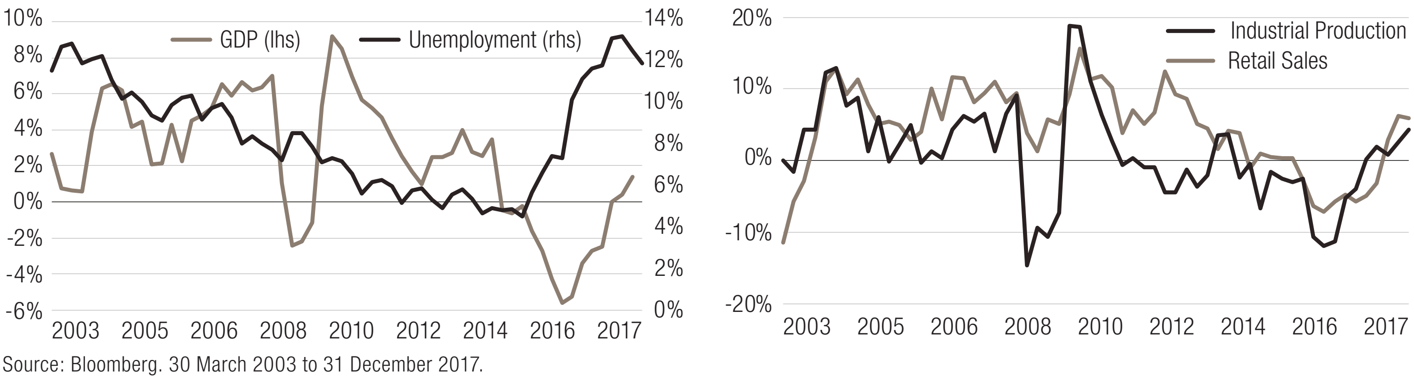
A more pressing example of major reform is the aforementioned revamp of the social security system, where delays to implementation remain in place. Indeed, just this week the government has conceded that federal intervention to counteract violence in Rio de Janeiro has forced the vote to be delayed yet again, with November now being touted as the next possible date. This essentially resets proceedings, with any reforms now heavily reliant on the administration voted in at October's election.

This is an important issue for ratings agencies, which are closely following these developments and there is no doubt that Brazil is risking a more widespread downgrade by holding back reform implementation.

Macro – positive post-recession

In the face of strong fiscal headwinds, Brazil's economy is actually building an impressive economic recovery, with positive growth in real GDP year-on-year in Q2 and Q3 2017. This follows 12 straight quarters of negative growth, bottoming at almost -6% in Q4 2015. Additionally, signs point towards this growth trend strengthening: activity indicators, in particular, industrial production and retail sales, are on a positive trajectory (Figure 2); higher commodity prices are increasing export values; and capacity utilisation figures of 78% highlight ample slack in the economy. This upturn is now also filtering into the labour market, where the unemployment rate has started retreating from the highs of 13% seen during early to mid-2017 on the back of such a severe recession.

Figure 2 – Brazil GDP and unemployment (left) and activity indicators (right)

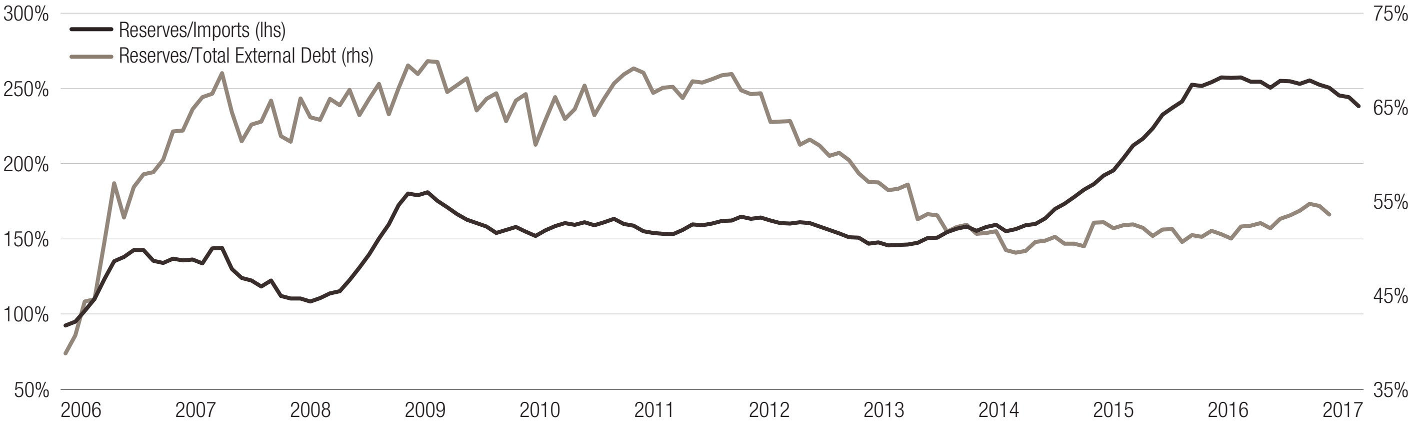


Source: Bloomberg. 30 March 2003 to 31 December 2017.

To cap it all off, the central bank has been helped by low inflation, allowing it to reduce the Selic Target Rate to record-low levels, most recently to 6.75% this month. Furthermore, although many expected this latest cut to signal the end of the central bank's easing cycle, inflation numbers released since then are still well below the target level of 4.5%, and as a result market consensus is now shifting towards another cut in the coming weeks.

On the external side, the current account stands at -0.5%, a significant improvement from the low of -4.4% in 2015. While investor sentiment was dire during the recession, leading to the trade-weighted BRL depreciating by 54% peak to trough since 2011, it has recovered by about 45% since then. FX reserves had been stable at an equivalent of USD 350 billion, which covers imports almost 2.5 times, a quite comforting buffer, as well as equating to 54% of total external debt (Figure 3).

Figure 3 – Brazil reserve ratios



Source: Bloomberg. 31 December 2006 to 31 December 2017.

The concern that taints such promising data is that the fiscal deficit is yet to really budge, and is still floundering at 7.8% of GDP. Without any swift reform approvals before the electoral campaigns truly take the reins, it is difficult to see an improvement anytime soon. Indeed, a volatile swing to a more protectionist regime could see the prospect of reforms worsen, posing a serious threat to the economic recovery, in our view.

Rating considerations

The rating downgrade from Standard & Poor's on 11 January 2018 came as a small surprise in terms of timing rather than occurrence. Many had expected that rating action would only occur after more clarity emerged on social security reform developments, to allow a full review.

The expectation remains that Moody's and Fitch will wait for a more formal review before taking action. However, the latest developments have certainly made the situation more pressing, with the likelihood of agency action increasing. The delay puts added focus on the electoral campaigns and whether the leading candidates show any intent on committing to reform progress. Nevertheless, we believe any downgrade by Moody's will match, and not exceed, Standard & Poor's downgrade of one notch to BB-, with Brazil's current fundamental profile sufficient to keep it above the B+ category. As Brazil is already rated sub-investment grade, we believe that a downgrade by Moody's to BB- would be met by a muted market reaction.

The real risk, in our view, lies in the unpredictable path that the election campaign ahead holds. The impact of a rising populist regime could be extremely detrimental to Brazil's recovery as a whole, let alone the already substantial budget deficit, in our view. If the fundamental outlook were to worsen, we believe further rating downgrades may occur.

Last May, Brazilian bond markets showed just how susceptible they are to political instability, with yields spiking on the back of bribery allegations against Temer – rising by over 170bps on one day in the 5-years segment. It is not difficult to envisage a scenario whereby a similar reaction could occur in this election campaign, which could snowball into a much larger concern if it were to hit investment flows and put downward pressure on the currency, in our view.

Prudence remains the key

Overall, we continue to have a positive view on emerging market local currency debt. Indeed, exposure to the potential upside in Brazil is necessary, in our view, as it is one of the higher yielders of the universe. However, but we think that a fundamental-driven approach to portfolio construction can help to mitigate downside risk.

Specifically, the fundamental allocation approach of Lombard Odier Investment Managers' Local Currency Bond Index (LOIM EMLC) puts a lower weight to Brazil against the Market Cap benchmark (4% versus 10%), largely due to Brazil's exceptionally weak budget deficit situation and delicate political position.

Figure 4 – Drawdown for LOIM EMLC versus Market Cap benchmark following Temer bribery allegations on 18 May 2017

Source: Bloomberg as at May 2017. Past performance is not a guarantee of future results.

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