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BRAZIL

WHAT'S BEHIND THE VOLATILITY?

KEY TAKEAWAYS

- FUNDAMENTAL AND MACROECONOMIC VARIABLES ARE NOT ENOUGH TO EXPLAIN REALIZED VOLATILITY THIS YEAR IN THE BRAZILIAN MARKET.
- THE UPCOMING OCTOBER PRESIDENTIAL ELECTION HAS BEEN MIRED WITH UNCERTAINTY, AND MARKETS HAVE UNDOUBTEDLY BEEN RATTLED BY IT.
- HOWEVER, WE BELIEVE NOT MUCH IS NEW HERE: PRESIDENTIAL ELECTIONS IN EMERGING MARKETS ARE USUALLY PRECEDED BY HIGH LEVELS OF UNCERTAINTY, ESPECIALLY IF THERE IS NO CLEAR FRONTRUNNER.
- IN OUR VIEW, BRAZIL CONTINUES TO BE AN ATTRACTIVE HOLDING, AND, AFTER THE DUST SETTLES, WE EXPECT TO SEE ITS STOCK MARKET RISE AGAIN.

Right now, Brazil is facing a presidential-election year, which is a source of great uncertainty in many emerging markets. This is especially true in Brazil this year, given two events: (i) the impeachment and removal of President Dilma Rousseff from office in 2016; (ii) the imprisonment of former President Lula Da Silva (2003-2011), which will very likely render him ineligible to run for the presidency this year. In spite of all this, we have strong reasons to be optimistic about the Brazilian stock market. What follows summarizes our views about how the political process might unfold, and how markets might react.

1. THE LULA FACTOR

- The final word on Lula's candidacy will not be heard before September 17th.
- That day, the electoral authorities will analyze the registered candidacies.
- The big question will be regarding the former president's eligibility.
- Lula may be disqualified given that he has been sentenced for corruption charges.
- So far, different views have emerged within the judiciary in relation to Lula's case.
- This only increases the uncertainty related to whether his name will appear on the October ballot.
- He is now leading the polls, and he has a good shot of winning if allowed to run.

2. POLLS

- Some analysts seem nervous in light of recent polls.
- But a careful reading of them provides a few reasons for pause.
- First, no candidate has a clear lead.
- Second, and even more importantly, almost half the electorate still checks the undecided box when asked whom they would support in October.

3. POTENTIAL OUTCOMES

- An ideal outcome would be for Geraldo Alckmin to win.
 - Why? He is a viable pro-reform candidate.
 - He belongs to the PSDB party, the same as former President Fernando H. Cardoso (1995-2003).
 - At the moment, the market's GDP growth expectations for 2019 are ~2.5%: an Alckmin win would immediately push this number up.
 - His main economic advisor is P ersio Arida, former chairman of the Central Bank of Brazil.
 - An Alckmin would also bring political risk (and therefore yields) down.
 - More prudent spending would be expected, lowering inflation and the need for the central bank to raise rates (which they have been reluctant to do anyway, hurting the currency).
- Right now, no candidate has a clear lead, as we explained before: Alckmin is placed fourth, after Lula, Bolsonaro (right-wing member of Congress), and Gomes (left-wing former governor).

- But we believe that Mr Alckmin will likely win the run-off if he qualifies for it (and Lula is declared ineligible).
- In July, he secured the backing of a large coalition of centrist parties (Centrão).
- He was vying for their support with Ciro Gomes, who also failed to cut a deal with Lula's PT party.
- When the news broke, the market gained 2% (7/20).
- The Brazilian real also gained against the U.S. dollar.
- This support matters a great deal because it will give the candidate extra time on TV and radio (mandatory time that has to be yielded to candidates).
- Alckim is generally regarded as a political moderate and a good manager, who has plenty of political and executive experience (e.g., he was the governor of São Paulo).
- Moreover, even though we view a win by Ciro Gomes as a negative right now, we believe he will moderate his platform if he becomes the leader (just like Lula did in 2002).
- Some of his statements so far are indeed worrying, but they are partly an effort to win over Lula's supporters.
- The recent win by López Obrador in Mexico could provide him with a blueprint to win and avoid rattling markets at the same time.
- A win by Bolsonaro should not scare markets, yet it is hard to see right now how he could broaden his support to win in a run-off.
- He has promised to privatize many public companies, and to do it fast.
- However, his performance last week on the second of nine debates raised even more questions about his ability to win support from undecided voters, or to expand his vote in the case of a second round.
- In any case, right now, with Lula out and such a large number of undecided voters, poll data show him advancing to the run-off election.

4. CHALLENGE #1: PENSIONS

- Major debate right now is the reform of the pensions system.
- The current government decided to kick the can down the road.
- The next government will have to tackle the issue, and it will not be an easy political sell.
- However, the Temer administration has passed important reforms, like the one introducing greater flexibility to the labor market.
- He has exceeded the expectations of those who thought he would act as a placeholder after the removal of President Rousseff from office.
- The economy is showing signs of recovery and corruption investigations (like the one that landed Lula in jail) are going strong, in spite of efforts to derail them.
- Curbing corruption – and deterring practices like the ones that looted the coffers of Petrobras – is key to Brazil's long-term prospects.

5. CHALLENGE #2: DEBT

- Debt is usually cited as a risk for Brazil's economy.
- An important distinction should be made between the total level of debt (public and private) and the yearly

budget surplus (or deficit) the government runs.

- According to the IMF criteria, the total level of public debt (federal, state, and municipal) reached 84% of GDP at the end of 2017.
- For emerging economies and middle-income countries the average is 50%; for developed countries, it is 105%.
- Overall, it is 82% of the global economy, so Brazil is an “average” country in this regard.
- The country will probably register a primary deficit in 2018 for the fifth consecutive year (which means no savings are being used to serve payments of previous debt), mostly a consequence of loose fiscal policies during the Rousseff administration.
- The current administration has made efforts to rein in spending.
- For example, the primary deficit for the year ending in May was only 0.03% of GDP.
- The government has faced, however, some unexpected bumps, especially the strike by truck drivers that forced the government to allocate new funds for diesel subsidies.
- In any case, the risk of default is still very low at present.

6. IS BRAZIL THE NEXT TURKEY?

- In a nutshell, no, we do not believe the two are comparable.
- First, the Brazilian government’s diplomatic relations with the U.S. are good, unlike Turkey’s.
- Brazil is a democracy, a fact unquestioned abroad: the president there is not viewed as an autocrat, and there are 3 independent branches of government.
- The fact that someone as powerful as Lula is in prison is evidence of this.
- The Brazilian government’s handling of the economy has beaten expectations.
- President Temer has enacted difficult reforms, even if more are still needed.
- His performance simply cannot be compared to Erdogan’s, who has implicitly told the central bank how to act, and even placed his son-in-law as minister of finance.
- Finally, Brazil will have a competitive presidential election in October, unlike Turkey, where the winner was known before any ballots were cast.
- Two of the three main candidates in Brazil are pro-markets; the big question is how far (and how fast) they will act in terms of major reforms.
- We believe that Brazil still represents an attractive investment opportunity today.
- Nevertheless, we expect to see increased volatility for the remainder of this year, which, in turn, may present itself as an additional investment opportunity.

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