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# Brazil: Belle of the Ball

Eric Fine, Portfolio Manager

*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. Policy, not politics, were a key focus, given the recent presidential and legislative elections, incoming President Jair Bolsonaro's inauguration, and a world that is less willing to finance EM. This report is a follow-up to our pre-election report (Brazil: Binary, Bumpy, Buy?), which includes relevant details on the economy and the fund's positioning.*

## Summary

Recent presidential and parliamentary elections support our generally positive view on Brazil. We still expect the government to focus on a speedy pension reform in the first quarter of the year, with approval perhaps in the first half of 2019, and we anticipate plenty of other positive news on the economic front as well, including privatizations. This positive momentum should make Brazil stand out as having a strong reform program, compared to other high-yielders that have questionable policies (such as Turkey and Mexico), are drifting (like South Africa), or face unique risks (like Russia and sanctions). As a result, we have maintained our overweight allocation to local-currency debt. A key risk to our view is that the commitment to pension reform has not been unequivocally expressed by newly-inaugurated President Bolsonaro. Instead, he has sounded on other themes, particularly social issues, that have been the focus of media attention and have repelled offshore investors.

## The Need for Pension Reform

- **Fiscal policy generally, and pension spending specifically, are Brazil's key weaknesses.** We reviewed this issue in our previous note. Suffice it to say, fiscal deficits were around 7.25% of GDP in 2018 (the highest of any major member of EM debt indices), with pension spending being a key and growing source of this imbalance. Without reform, the country would face a spiraling debt dynamic (General Government Debt/GDP is 77%, as of November 2018), exacerbated by a weaker currency, higher inflation, and thus higher borrowing costs.

- **Almost every other macro indicator is very strong.** Brazil has plenty of dollars (from both its $370B stock of reserves and the flow from the current account's small deficit of 1% of GDP, in addition to its foreign direct investment (FDI) inflows). Inflation, in our view, also seems very well anchored at around 3%, given high capacity, high unemployment, the end of the worst depression in 100 years, and a central bank that maintained high real interest rates. We expect the central bank, in fact, to be more comfortable with lower real interest rates, if/when pension reform is passed.

- **Asset price outcomes depend on addressing pension reform.** As a result, the market has focused on the incoming government's disposition and, in particular, whether political capital will be spent to get this risk "out of the way".

- **Brazil has a spotty track record, making progress key.** Over the past couple decades, one could argue that "good periods" in Brazil were largely due to luck. Commodity prices rallied, which strengthened the currency, reduced inflation and borrowing costs, and boosted the political prospects of the perceived progenitor. Although a bit of a caricature, our point is that these "good periods" saw consistent growth in government debt and volatile inflation (and thus interest rates) as a result. Reform rooted in reduced spending and borrowing has yet to happen, but the need is acute.

## The Government Appears Focused and Capable

- **Appointments to key economic positions have been unequivocally positive.** Paulo Guedes, the country's new Economy Minister, is a proud "Chicago boy" (a reference to his PhD in economics from the University of Chicago, the source of many successful reformers including, most notably, the Chilean economists who transformed Chile's economy decades ago). Appointments to Treasury, the state development bank, and others, are all cut from the same extremely supply-side/reform-oriented cloth. The problem is that President Bolsonaro himself hasn't chimed in clearly on pension reform as a priority-spend of his political capital.

- **We believe it still seems likely that the incoming new government will prioritize pension reform.** The government's top economic advisers say so. Logic (see the game theory comments below) points this way as well. Even if progress towards needed pension reform is delayed or bogged down by work on bolder reform programs, they are nonetheless bolder and aim for greater and longer-lived savings.

- **Following his recent inauguration, we are hopeful that uncertainty surrounding President Bolsonaro's commitment to pension reform will be removed.** Minister Guedes is repeating what he said during the election: that pension reform is the government's key initial focus. An important ally in getting pension reform through the legislative process would be Rodrigo Maia, the former president of the Senate, who faces reelection (by the newly elected Senate) in February. He has already received key endorsements. Speaker Maia's reelection is going to be closely watched, given President Bolsonaro's repeated calls for a new political strategy. He criticizes the past strategy as, essentially, paying off legislators with money and cabinet positions. He says he wants votes on merits and is promising to not play this game. An experienced hand such as Maia's (who supports pension reform) may help calm markets, in our opinion.

## Good Economic Policy News While Pension Reform Awaits

- **There is likely to be good policy news coming from Brazil, with or without a speedy focus on pension reform.** We remain stunned by, for example, privatization being part of the current government's policy platform, when just nine months ago any privatization program from any candidate seemed inconceivable. Deregulation should be another source of good news. FDI appears set to increase, as global investors reassess a Brazil that has lurched hither and yon for decades. More specifically, in 2019 we expect a steady stream of positive headlines on auctions of roads, ports, airports, the oil sector, and the lottery.

- **Brazil's good policy news appears in an EM world with little of it.** This article is not about Mexico, but we see growing tensions there between promises to spend and promises to hit budget targets, along with other problems. Turkey's economic policy is turning very heterodox, in our view. South Africa looks to be drifting. Russia's economic policies are arguably the best in the country's history, but are made virtually irrelevant by the sanctions/political risks emanating from the U.S. Good policy in Indonesia is incomplete, and the government seems uncomfortable allowing the currency to strengthen.

> Among high-yielders, in other words, Brazil legitimately stands out.

## Global Environment Magnifies Risks and Opportunities

- **In a benign global financing environment for emerging markets, time may not be of the essence.** Given that the need for pension reform is broadly recognized in Brazilian politics, and that our primary concern is that more perfect reform proposals take time, a relaxed world financing environment would mean that the country's large fiscal deficit (at over 7% of GDP) could be financed without major hiccups. Financing is always a function of hope about the future.

- **However, a tougher global financing environment would necessitate strong and early support for pension reform.** Although Brazil's fiscal deficit is largely financed by domestic investors, the cost is highly variable. This is because any setbacks to pension reform could feed into a weaker currency, higher inflation, and thus higher domestic interest rates. Recall that inflation approached 10% just three years ago, compared to the roughly 3%-4% currently. High interest rates (that would ensue), bad fiscal policy, and weakened growth prospects (in the event of a tough global environment) would mean a challenging debt dynamic.

### Noteworthy Risks to a Speedy Move on Pension Reform

- **Despite our optimism, we are surprised by the lack of urgency on pension reform.** This was one of the key takeaways from the visit. In fact, our trip was planned prior to President Bolsonaro's inauguration, in anticipation of some clarity and focus on the country's key reform need. Our sense following the visit was that although the economic team is very desirous of showing progress to market participants, it isn't clear that it is a priority for the new president.

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- **"Fast is better than good" is not being signaled.** In our view, and the market's, the new government should invest its political capital in getting *some* social security reform approved. The well-formed legislation already put together by the previous government, which had also crossed many legislative hurdles, would be an easy score. No single piece of legislation will put social security to rest as a key risk. The assumption is that there will be *many* adjustments over the years, regardless of what gets approved initially. As a result, showing political will and focus on the issue should be the priority, not reaching some unachievable policy nirvana.

- **There are too many discussions of alternative reform plans, and not enough unequivocal support from President Bolsonaro.** Our trip involved meetings with architects of different social security reform programs. They are without question superior, in our opinion. Generally, they are more comprehensive and pave the way for a new system in which pension liabilities will become "capitalized" with contributions into a system (rather than a general budgetary obligation). They may take over a year to negotiate, by which time the new government's political capital may be exhausted.

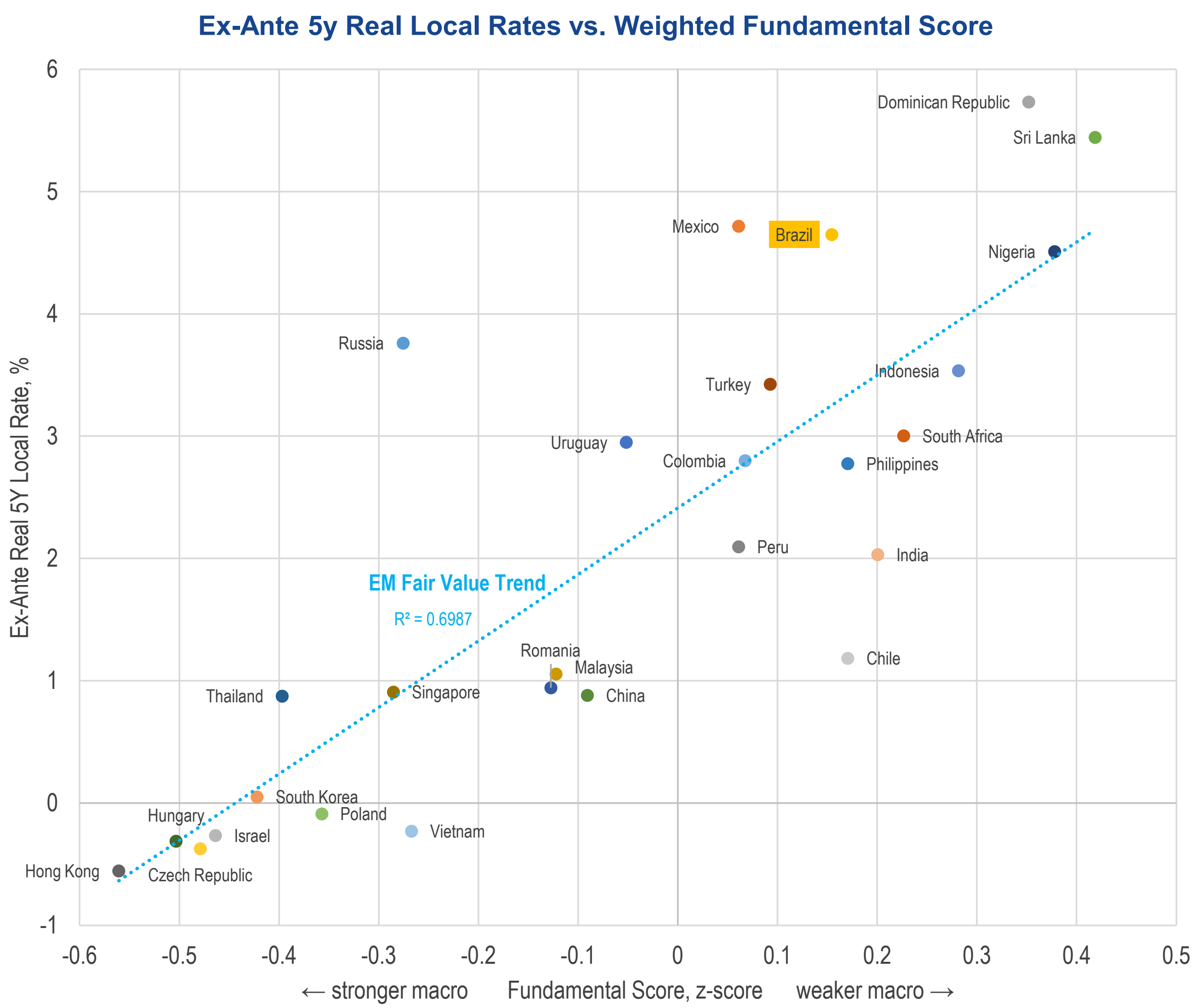
- **There was a hopeful recent development.** Jose Marinho was appointed Secretary of Social Security. He, too, said the government will use the legislatively-advanced proposals of the outgoing Temer administration. He also said that there will only be small modifications, speeding up the process. One news source cited the proposal as raising the minimum retirement ages to 65 for men, and 63 or 65 for women, which is a tough and specific initial position.

- **Without progress come risks.** If Brazilian politics get bogged down by a long discussion of new reform programs, we worry not only that political capital will dissipate but also that a serious market challenge (of whatever provenance) will have significant implications for Brazilian asset prices. Putting in reforms *after* the market is forcing them is more costly, and less likely. This simple game-theory is well-known – you strike when the iron is hot. And Brazil's neighbor Argentina just provided an example of how this can go wrong (i.e., not pushing through tough reforms when they can be done, resulting in an economic crisis that made – in their case – fiscal reform both more necessary and more politically costly).

## Conclusion

We remain bullish overall on Brazil, despite our concern about the president's commitment to pension reform. We find local currency particularly attractive now, due to their high real interest rates relative to fundamentals. Moreover, many of the other high-yielding alternatives – Turkey, Russia, South Africa, and Mexico – don't have convincing policy momentum. Throughout most of 2018, we preferred corporates and quasi-sovereigns such as Petrobras.

We are also comfortable with duration. In our previous report, we noted that following pension reform, the central bank was likely to inaugurate a re-think of its R-star (its "neutral" real interest rate), allowing a lower real interest rate more in line with countries with better track records and economic conditions. The market has priced a lot of this in, but we see more to go, particularly given the more benign interest rate environment in the U.S.




VanEck Research, Bloomberg. Data as of 12/31/2018.

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