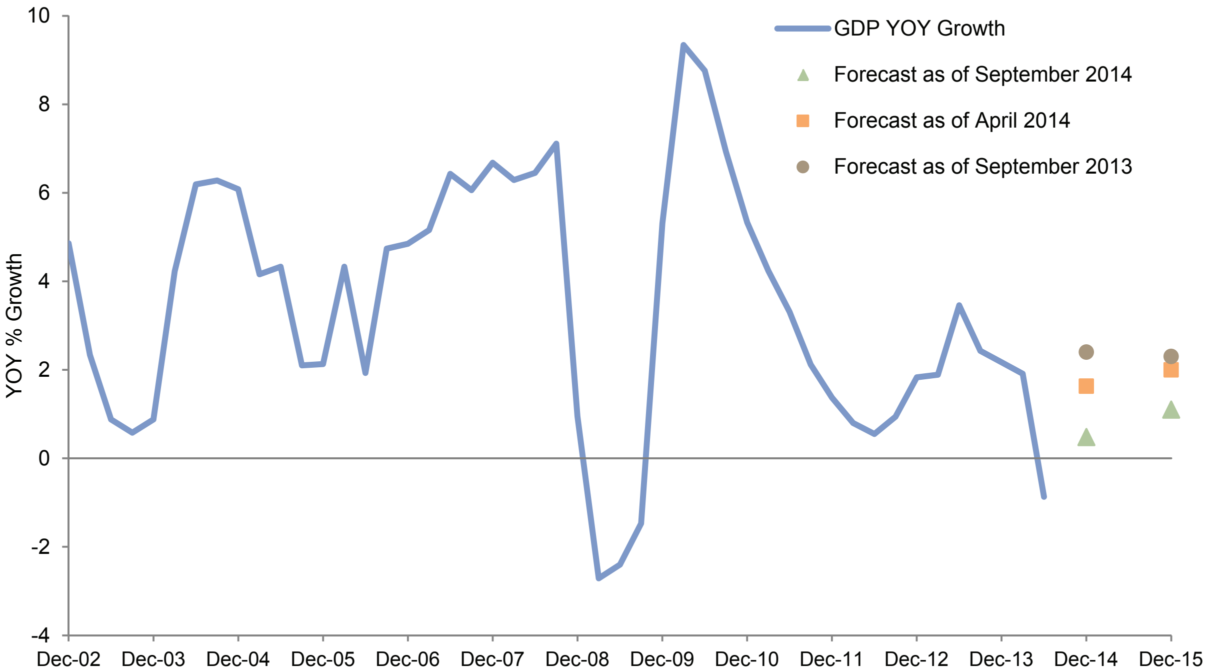
Brazil's Election Is Weeks Away, But Investors Have Already Voted

After a difficult 2013 that saw significant volatility in the *real* and Brazil identified as one of the Fragile Five, Brazilian markets have roared back in 2014, with the MSCI Brazil notching a 19% gain through August 31 (25% for unhedged, US$-based investors, as the *real* found its footing, rising 5% versus the dollar). Local currency government bonds have returned 11.1% (unhedged) year-to-date as of September 16, 2014. The 2014 rally in Brazil's investment markets is not wholly unique, of course, but the country's 2014 returns are standouts, especially considering that the world's seventh-largest economy dipped into recession this summer, and that analyst forecasts for full-year 2014 GDP growth have plummeted from more than 2% a year ago to just 0.5% today.

The key catalyst for the strong 2014 returns has been President Dilma Rousseff's dwindling re-election chances. Poll results for next month's presidential elections have increasingly favored candidates other than incumbent Rousseff, and investors are enthusiastic that the leading candidate to replace her (Marina Silva—an environmental activist who entered the race only this summer) will be less of an anathema than Rousseff to advocates of market-based policies.

Whichever candidate wins, implementing reforms will be quite challenging. Even if the next president's reforms surpass today's elevated expectations, some of the country's key challenges will remain: corporate and consumer indebtedness, an uncompetitive economy and poor infrastructure, and reliance on Chinese commodity demand.

Brazil GDP Year-Over-Year Growth
2002–15

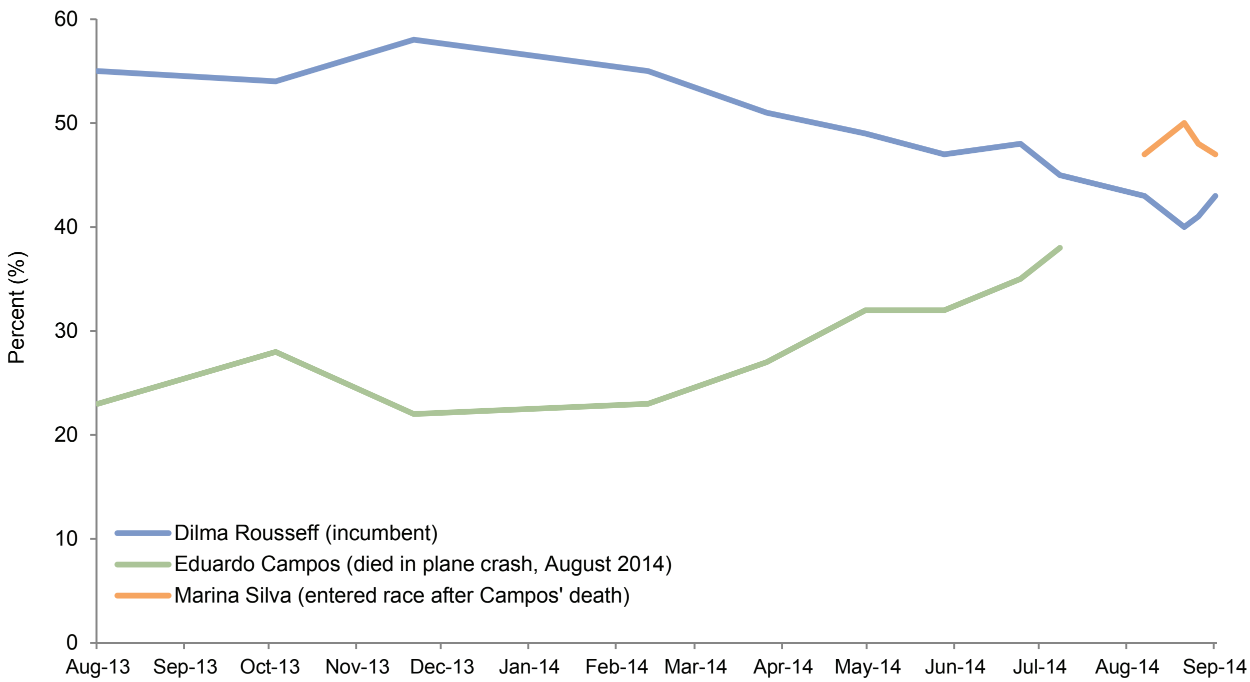


"Investors Cheer as Environmental Activist From Socialist Party Pulls Ahead in Polls"

The through-the-looking-glass headline above is the product of our imagination, but it would actually be a thoroughly accurate assessment of the situation in Brazil today. After four years as Brazil's president, Rousseff has fallen behind in re-election polls. The candidate voters increasingly indicate they would favor in a likely runoff is Marina Silva, a rubber tapper–turned-senator who entered the race for president only last month. Silva became a candidate when former Brazilian Socialist Party (PSB) candidate Eduardo Campos died, after his campaign plane crashed near São Paulo.

Voters appear keen on Silva's personal story and outsider status. In February, 55% of polled voters signaled that they would support Rousseff in the event of a runoff; that has dwindled to just above 40% as of this month, with Silva garnering the professed support of 47% of voters and thus taking the lead from Rousseff.

Brazilian Presidential Election Polls: Support for Various Candidates in the Event of a Runoff Election
August 9, 2013 – September 9, 2014



Ambitious Reform Plans, Difficult Political Realities

Investors, in turn, are cheered by Silva's ambitious economic policy statements and reform agenda, and their architect Eduardo Giannetti de Fonseca. The message from Silva's camp? Her administration would push for freely floating exchange rates, an autonomous central bank, credible inflation-targeting, an end to the most egregious price controls and subsidies, and fiscal responsibility.

Would a Silva administration be able to usher in these ambitious reform plans? The country's byzantine political structure and formidable bureaucracy will make progress exceptionally difficult. A total of 22 political parties are represented within Brazil's congress, and eight of the parties have at least a 5% share of seats in the country's lower chamber. Coalition-building and doling out "pork" and patronage has traditionally been an important way of effecting governmental change in Brazil; as an outsider, it's not clear Silva would be successful in taking that approach, even if she were so inclined (her supporters say that she may hold national votes to push agenda items, rather than the traditional approach of doling out cabinet posts to minority-party officials to build coalitions). If Rousseff manages to stay in office for another term, the odds of substantial reform would shrink further.

Post-Boom Challenges Will Remain Once the Polls Close

Even if the next president is able to enact some helpful reforms, Brazil will continue to face plenty of challenges: the country will remain reliant on Chinese commodity demand and has an ongoing debt hangover that the Chinese boom helped engender. And Brazil will struggle to move away from reliance on commodities because its bureaucracy, poor infrastructure, and limited competitiveness hamper foreign investment in non-commodity businesses.

The Brazilian economy grew by 44% in real terms from 2003 to 2013 as Chinese commodity demand soared.[1] The boom brought benefits to Brazilians, including compensation that increased 34% in real terms over the period.[2] However, the hangover is now underway:

- **Reliance on China.** While Brazil manufactures and exports a variety of goods (for example, it is the world's fifth largest aerospace exporter, thanks to the global popularity of Embraer regional jets), commodity exports are significant, particularly agricultural products (soybeans, sugar, coffee) and minerals. Chinese demand drove growth for many of these commodities. From 2005 to mid-2014, for example, Brazil's iron ore exports grew approximately 70%, with nearly all of the marginal increase going to China. China has downshifted its demand as growth and investment decelerate, which has impacted the export volume and high commodity prices that Brazilian industry had become accustomed to. In addition to the impacts on the real economy, resource-related firms make up one-third of the market capitalization of Brazil.
- **Debt.** The boom spurred a significant borrowing binge, with governments, corporations, and households getting in on the act. Household debt jumped from 18% of household income in 2005 to 46% in 2014 (and this debt largely stems from consumption and car purchases—mortgages are only about one-third of the total). Brazilian corporations added about $200 billion in net hard-currency debt to their balance sheets over this period as well; resource-related companies account for half of the debt load of non-financial corporations.
- **Limited Appeal for Non-Commodity Investment.** It is not obvious what will take up the Chinese commodity mantle and drive Brazil for the next decade. Despite the country's large domestic market, its appeal to CEOs on the lookout for new

[1] Brazil is a leading supplier of iron ore, soybeans, coffee, and other commodities. Commodity exports are about 6% of GDP.

[2] Refers to the median monthly income from primary employment (not including second jobs) of employed Brazilians, summed to produce annual data for both 2003 and 2013.

production facilities may be limited. The country's bureaucracy and low labor productivity[3] are legend. Infrastructure is poor, with Brazil investing just 2.2% of GDP in infrastructure, versus 5.1% on average for the developing world. Wages are also high relative to competing countries, particularly per unit of productivity. Finally, taxes are high and labor laws are rigid. The World Economic Forum ranks Brazil at 57 on its global competitiveness rankings, below South Africa and Russia.

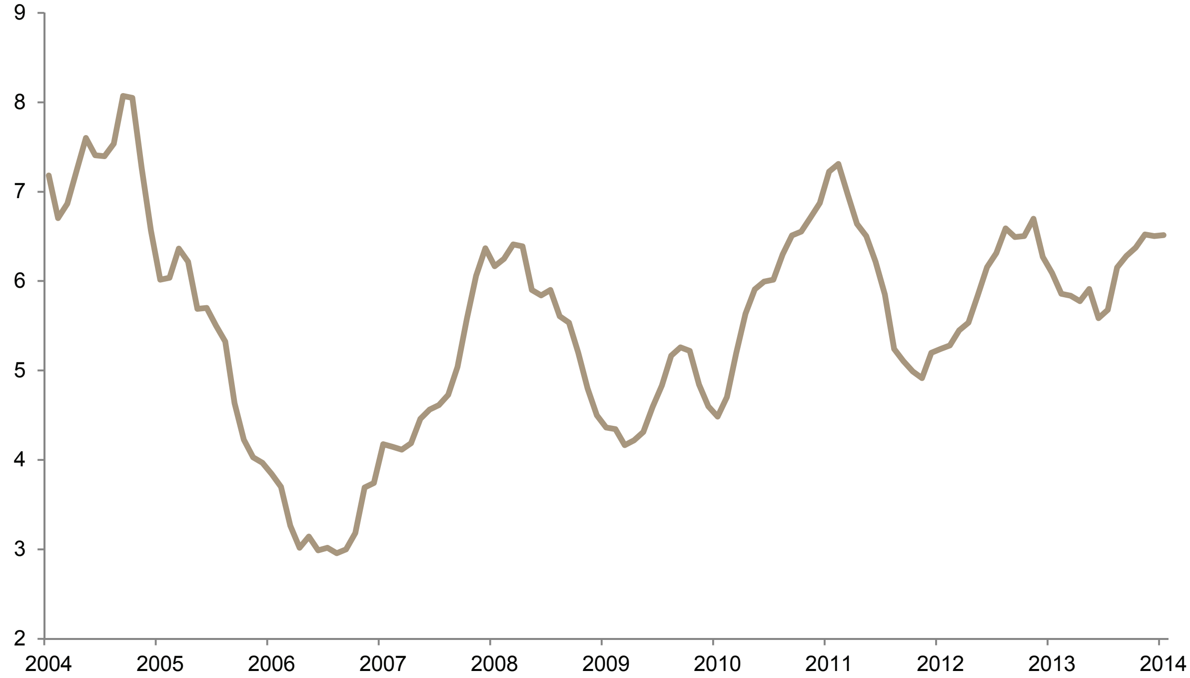
Silva's reform agenda (which strikes us as very ambitious) aims to fix some of these ills; even if her agenda is completed, other challenges such as the debt overhang will persist.

Whither Inflation and the Real?

An independent central bank, credible inflation targeting, and fiscal discipline—all aspects of the platform mooted by Silva's team recently—would likely be difficult to implement, but they could provide substantial long-term help remedying some of the pressures in the Brazilian economy today. Inflation remains stubbornly high at 6.5%. The central bank has pushed short-term interest rates to 11% in an attempt to control this (and likely to

[3] GDP per employed person is about $20,000 for Brazil, compared to roughly $40,000 for Chile and Mexico, and more than $60,000 for South Korea.

Brazil Consumer Price Index
August 31, 2004 – August 31, 2014



support the currency), but this very restrictive monetary policy is hardly a shot in the economy's arm. Silva has promised to remove price caps on energy, which would likely boost inflation in the near term; however, the country's economic slowdown might keep price pressures in check. While Silva has cast her vote for not intervening in the exchange rate, the point may be moot at some point in the medium term. The country's economic weakness and high inflation are likely to continue to put downward pressure on the *real*. A weaker *real*, combined with revenue pressures in the commodity sector, could lead credit problems in Brazil to spread beyond last year's default of OGX.[4]

What's a Global Investor to Do?

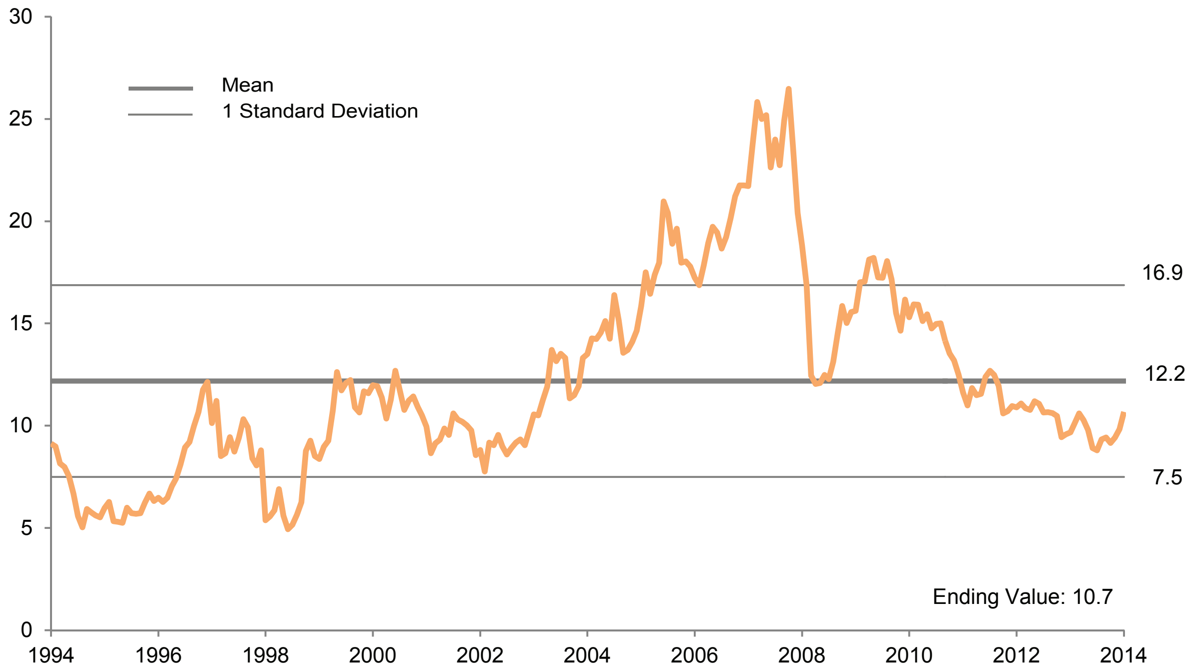
The situation for Brazil is gloomy. The prospect of a new president has cheered investors, but even if Silva's poll lead turns into an election victory, her reforms could be very difficult to implement. It's difficult to see things turning around quickly.

Should investors underweight the country's shares, which are substantial components of emerging markets debt and equity indexes? We don't think so. Current valuations incorporate substantial pain already. The MSCI Brazil Index trades at a reasonable 10.7 times composite normalized earnings, versus an average level of 12.2 over the past two decades. Given the very high inflation of the early 1990s, shell-shocked investors likely demanded lower valuations than they would today; for that reason, the historical average for the period may be a tad below a "true" fair value multiple. However, prices have rallied recently based on (a) expectations for an election that replaces the current president and (b) that the replacement would successfully enact substantial reforms; if either of those criteria is not met, selling by disappointed shareholders could lower share prices materially.

The Brazilian index is quite top-heavy, with five firms accounting for nearly half the index's market capitalization, so active managers may own portfolios much different from the index. However, several equity managers familiar with the Brazilian market agree with us that valuations are reasonable. While investors may be tempted to assess Brazil based on the country's medium-term growth prospects, typically a country's economic growth has little correlation to its equity returns, because by the time stronger growth becomes apparent, valuations usually are already elevated. In this case, just a whiff of political change has been enough to drive up share prices, even with little sign of an imminent economic turnaround.

[4] It would also increase competitiveness, but labor-productivity gains and better conditions for businesses are more important and more durable steps to bolster non-commodity investment. While *real* weakness would pose a danger to firms that borrowed in dollars or euros, it is not as large of a risk to Brazilian government funding, in our opinion: hard-currency government debt is only 20% of GDP, below many other emerging markets.

MSCI Brazil Composite Normalized Price-Earnings
August 31, 1994 – August 31, 2014



The Bottom Line

Brazil's large economy is weaker than many in the emerging world, and enthusiasm over recent polls may be overblown (and any election disappointment could pressure Brazilian shares). Still, a neutral position on the country's equity market remains the right stance in our view. ■

Contributors

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Exhibit Notes

Brazil GDP Year-Over-Year Growth
Sources: Bloomberg L.P. and Brazil Central Bank.
Note: Forecasts represent consensus forecast posted by the Brazil Central Bank.

Brazilian Presidential Election Polls: Support for Various Candidates in the Event of a Runoff Election
Source: Datafolha.

Brazil Consumer Price Index
Source: Thomson Reuters Datastream.

MSCI Brazil Composite Normalized Price-Earnings
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The composite normalized P/E ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and ROE-adjusted earnings. All data are monthly.