Confidence must be earned

Amundi ASSET MANAGEMENT

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Brazilian elections: Lights and shadows on the horizon

INVESTMENT TALKS

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- ***The outcome:*** *The expected outcome of the presidential election occurred, with right-wing candidate Jair Bolsonaro (PSL) winning vs the leftist Fernando Haddad (PT). Post the first round, Bolsonaro appeared to be the favourite, based on discontent with established politics. However, Brazil's political path is unlikely to be straight-forward: a solid coalition is necessary to set important reforms, but this does not appear to be on the cards.*
- ***Implications for financial markets****: In our opinion, this outcome could still result in economic policy mistakes that could have a significant impact on business and consumer confidence as well as investor sentiment. At this time, considering that the stock market had already rallied and equity valuations are not cheap overall, we would maintain a neutral stance on equities. However, we would shift to a more positive stance as soon as supportive signs emerge. Regarding fixed income, we are positive on the credit market, which is expected to remain relatively stable in the upcoming months and where valuations still look reasonable. With regard to currency market, we have a positive view on Brazilian real against other EM currencies.*
- ***Impact on the macro situation****: Brazil's vulnerability is mostly related to domestic situation; so, the impact of a new administration on the macro environment mainly depends on how important reforms unfold. If the new government doesn't offer positive signs in the short term (diluted pension reform would be a positive), the impact could come via business/consumptions confidence impacting investment decisions. In the event that fiscal reform (more needs to be done in this regard) is not implemented, we are likely to see impacts in the medium/long-term. Awaiting signs regarding what is to come from the new government, we remain cautious with respect to the consensus forecasts, with GDP growth estimated to accelerate to 2.0% next year and 1.8% in 2020.*

"We prefer to maintain a neutral view on equities at the moment. We are positive on the credit market as we expect it to remain relatively stable".

How might this outcome affect Brazil's financial markets?

YS: Most of the optimism regarding a Bolsonaro victory has already been priced in by the Brazilian stock market, which rallied after the first-round results, mainly based on expectations that "market-friendly" reforms initiated by the former government would continue under a Bolsonaro government.

In our opinion, this outcome could still result in economic policy mistakes which could have a significant impact on business and consumer confidence as well as investor sentiment.

At this time, equity valuations do not look that cheap overall and we expect a pullback of the market with possible profit taking in the near term. Then, we could see some additional upside in the event of any signs of reforms (especially pension and fiscal reforms), but we prefer to maintain a neutral stance on equities as political debates still are very fluid and government positions could change rapidly. However, we would shift to a more positive stance as soon as supportive signs emerge. We have a favourable view of state-owned enterprises (such as Petrobras), where turnaround prospects could contribute to an ongoing improvement in company management. We also focus on competitive export companies with still-attractive valuations and companies in cyclical-sectors that could benefit from a further economic recovery.

In fixed income side, we are positive on the credit market, which is expected to be relatively stable in the coming months and where valuations still look reasonable. We are more focused on individual companies with high-quality/long-term prospects and solid fundamentals.

With regard to the currency market, the Brazilian *real* has recovered some of its lost ground vs the US dollar since the beginning of the month, but still remain one of the worst-performing currency in the EM universe and we do not expect it to stay at current levels for very long. As we believe the US dollar is set to remain strong in the coming months, we prefer to maintain a cautious approach on the USD/BRL while remaining positive on the *real*'s performance vs other EM currencies.

"The capacity of the new government to build a solid coalition and to execute important reforms will be a key factor for assessing the Brazilian situation in the short term".

What look to be the main challenges for the new government in the coming months?

AB: In the runoff, Jair Bolsonaro (PSL) won by a significant majority over Fernando Haddad (PT). However, President-elect Bolsonaro is starting with a lower approval rating than his predecessors (Dilma Rouseff and Lula). The new president does not have enough support in the two houses to enable him to easily pass important reforms requiring constitutional changes (which need at least 60% of votes). Thus, he will need to build a solid coalition.

In the short term, two issues should be monitored in order to assess the new government's capacity to pass the relevant bills/reforms: formation of the new cabinet and the approach to widening the coalition in the Congress. The few names mooted so far bode well in terms of ability and willingness to proceed in a market friendly direction: a representative in the Democrats party as possible Chief of Staff (Onyx Lorenzoni) and a University of Chicago-trained economist as Economy Minister (Paulo Guedes).

The economic agenda released by Guedes soon after the first round results has created much-needed positive noise: 1) pension reform; 2) reducing interest payments; and 3) reform the state towards a more liberal and efficient direction. A further point has been added with regard to accelerating the privatizations process.

Having said that, the path ahead will not be easy. With regard to pension reform, the most likely outcome is of modest changes (either the legislation already passed under Temer in the Lower House or new legislation incorporating at least a gradual increase in the minimum retirement age). That could bring some results in a relatively short term period; however, it is worth noting that whatever diluted reform does end up being passed, it will likely miss the objective of putting the country on a path of fiscal sustainability. Engaging the Congress in an ambitious pension reform would likely be more challenging and time consuming with respect to the approval process (and the final outcome uncertain). Building and maintaining a solid coalition is not the only issue here; testing the effective autonomy of the Economy Minister is another. Speeding up the privatization plan, as mentioned by Guedes, will test Bolsonaro's nationalistic approach regarding the retention of so-called strategic assets such as Eletrobras and Petrobras (or at least the most relevant parts of these entities).

How do you think these election results will impact on the general assessment of the macroeconomic situation?

AB: In our view, in the short term, the impact should relate to business/consumptions confidence impacting investment decisions if the new government doesn't offer any kind of reforms. Diluted pension reform would represent a great result in the short term. However, in order to have a more relevant impact on the medium/long-term, the government should undertake a more ambitious reform to put the country on a more sustainable fiscal path. We remain cautious with respect to consensus forecasts, and we estimate GDP growth hitting 1.2% in 2018, rising to 2.0% next year, and declining slightly to 1.8% in 2020.

"Implementation of reforms is needed in order for the domestic situation to be stabilised in the medium/long term".

The macroeconomic outlook for Brazil deteriorated significantly in 1H18. The strike in May impacted economic activity in the country, but this has proven to be a temporary shock. Domestic fundamental drivers still point to a decent recovery ahead. Industrial production and capital goods growth is stabilizing around the peaks of the year and real wages are growing, although at lower rates than in the past, due to a pick-up in inflation. The unemployment rate is decreasing somewhat from the recessionary peaks and capacity utilization has shown mild increases.

Inflation is at historically low levels, but it is expected to rise towards 5% on average in 2019. We would note that this is still within the Central Bank of Brazil's (CBC) target range. Higher inflation would erode household purchasing power, limiting the strength of a recovery.

The CBC completed its easing cycle quite recently and expectations for it taking a more hawkish stance increased during the summer on the back of the depreciation of the *real* and its impact on inflation expectations. We do not expect the CBC to raise rates in the short term.
The vulnerability of the Brazilian economy perceived during the summer did not relate to the country's external position: its small capital account deficit is more than compensated for by a healthy balance in foreign direct investments, external debt is low and mostly domestically owned. Finally, reserves adequacy ratios are quite sound.
Brazil's vulnerability is associated with unsustainable fiscal dynamics (government debt is expected to be 90% of GDP in 2019, according to the IMF), magnified by a period of poor economic performance and the uncertainty regarding the outcome of the elections (and with regard to the willingness and ability of the new legislature to pass necessary reforms).

How do you think EM will perform through the end of 2018 and into 2019?

"The EM investing landscape will remain challenging over the coming months, but we expect it to improve from 2H19".

YS: After a challenging year for EM assets, we still expect to see some pressure experienced by both the equity and fixed income asset classes through year-end and into 2019 as the Fed continues to normalise its balance sheet and raise rates, the USD remains strong for a period, and trade issues still take centre stage.
We believe that conditions will progressively improve through 2H19, when we think some interesting entry points will start to materialise.
In the year ahead, we prefer US dollar debt, as valuations for local currency debt do not look particularly attractive regarding the asset class.
We expect that equity market volatility will remain high, but some upside could materialize based on the recent correction, even given a decelerating global cycle. We focus on countries with supportive fundamentals, good valuations and solid macroeconomic features.
A very selective approach will remain key to navigating the ongoing challenges; in particular, investors will need to carefully monitor external vulnerabilities over the next few months to determine the winners and losers among EM.