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What’s going on in Brazil?

In this feature article, we explore the economic outlook in Brazil, the second largest economy in Latin America, and suffering the third largest coronavirus outbreak globally. We briefly explore the size of the outbreak, the subsequent economic slowdown, and then discuss the fiscal response and possible outcomes moving forward as the government tries to balance the interests of investors and the public at large.

This article has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

In response to the pandemic the government unleashed the biggest fiscal response in EM, totalling 18.2% of GDP, but now finds itself caught between a rock and a hard place. On the one hand premature and planned withdrawal of this much needed stimulus in early 2021 may cause the economy to fall off a cliff but help satisfy spending caps and investors looking for fiscal discipline as government debt approaches 100% of GDP.

On the other, continued stimulus will mean abandoning fiscal caps and increasing debt further to support a vulnerable population. This could put upward pressure on bond yields and cause an inflationary impulse which would force the central bank’s hand to hike rates and stymy the recovery.

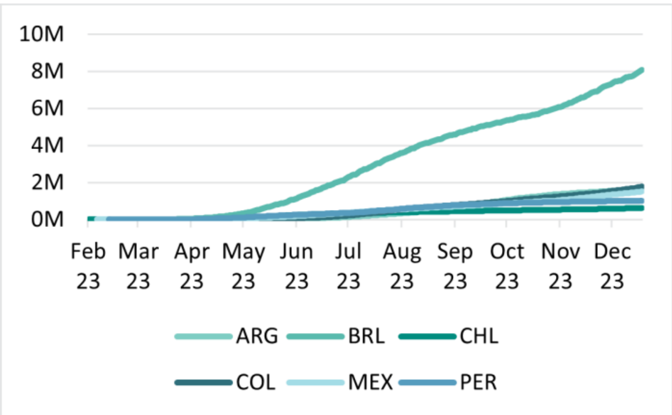
Money markets and a steepening yield curve seem to be pricing in the latter as the most likely outcome. Populist president Bolsonaro and half of the senate are up for re-election in October 2022 and will likely aim to please the voter base leading into this.

With over 8.2mn officially recorded cases and 206k deaths, Brazil has suffered from the largest outbreak of coronavirus in the region (see Exhibit 1). Tests per million are low compared to the G20, and excess mortality data shows a 22% gap between deaths caused by COVID-19, and those caused by respiratory and other unspecified causes. This data indicates that the outbreak is much larger than inferred by official numbers.

GDP growth contracted an estimated -5% in the first three quarters 2020, and the economy remains 4.1% smaller than it was pre-pandemic, unemployment remains elevated at 14.6%.

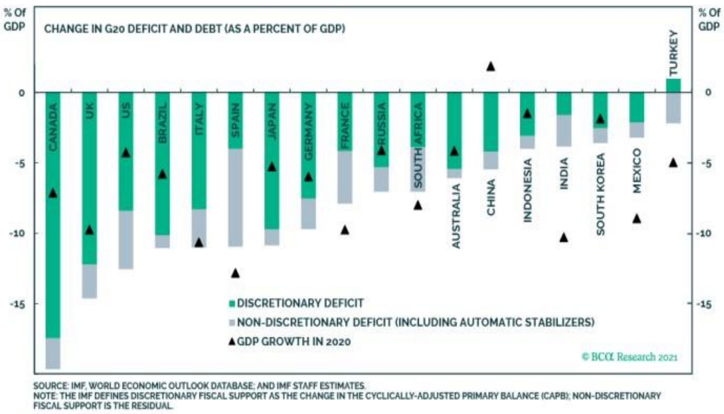
Populist President Bolsonaro has been loath to support lockdowns in response to the outbreak, referring to the virus as a ‘little flu’. Rather, congress declared a state of public calamity in March of 2020, allowing the federal government to circumvent hard-budget constraints, paving the way for a fiscal and quasi-fiscal stimulus totalling 18.2% of GDP, the largest in EM and one of the biggest globally!

Exhibit 1: Brazil has the largest Coronavirus outbreak in LATAM



Source: As-Coa.org

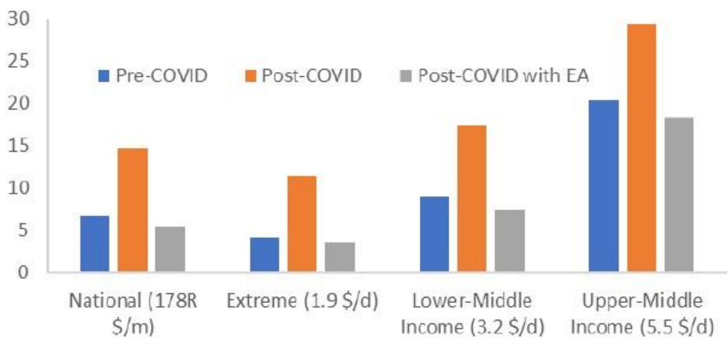
Exhibit 2: The Brazilian budget deficit rivals DM counterparts



Source: BCA

Government expenditure will bounce from 20% of GDP in 2019 to an estimated 27% in 2020 while the budget deficit will blow out to 12% (see Exhibit 2). One of the cornerstone programs of the response is the 'corona-voucher' initially offering informal and unemployed workers R$600 (US$115) or 60% of the minimum wage per month. Remarkably, this program has reduced the level of poverty in Brazil to better than pre-COVID-19 levels and prevented 16mn people from falling below the poverty line (see Exhibit 3).

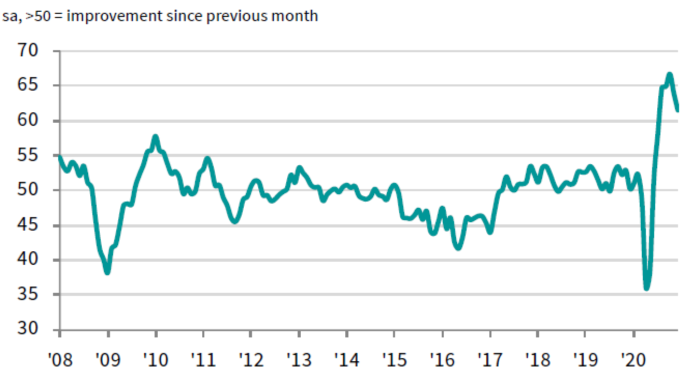
Exhibit 3: The Corona-Voucher has lifted Brazilians out of poverty



Source: As-Coa.org

This economic sugar-hit has led to a record high bounce in the manufacturing PMI from 36 in April to 67 in October (Exhibit 4). The PMI is a forward-looking indicator which surveys purchasing managers intentions, a number above or below 50 indicates expansion or contraction from the month prior.

Exhibit 4: Brazilian Manufacturing has rebounded sharply



Source: IHS Markit.

This bounce in manufacturing, along with income support for the poor, has led to a sustained increase in President Bolsonaro's approval rating where a record 37% of voters view his government's work as good or great, and perhaps more importantly 52% of the population do not blame him for the deaths caused by COVID-19.

Bolsonaro's newfound popularity may be the catalyst for continued stimulus leading into elections in 2022, while premature reduction of spending or hand-outs would surely cause the fragile economy to falter, leaving Bolsonaro with little chance for re-election. The uncertain fiscal position is manifesting itself through the steepening of the long end of the Brazilian Government 10-year bond yield curve and currency weakness.

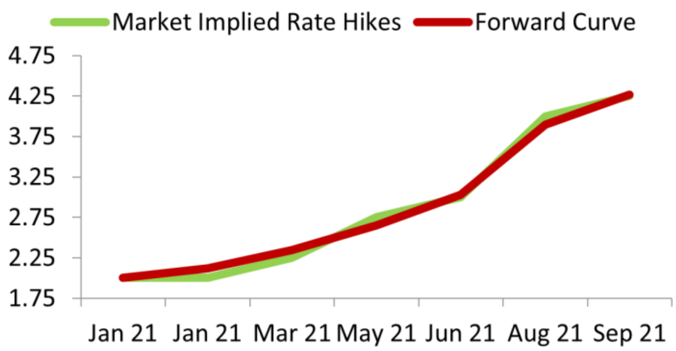
The Brazilian Real tends to correlate with commodity indices but even with strong commodity price tailwinds as iron ore, soya beans and the oil price surge leading out of the pandemic, the BRL has not appreciated. It is likely that the currency is failing to recover as foreign investors remain cautious while the fiscal position remains uncertain, instead opting to take a 'wait-and-see' approach to policy before returning to the country.

The weak currency has also contributed to a surprise bought of inflation, when currencies are weak manufacturing input costs rise as manufacturers buy foreign parts to build their goods. This has been a key issue for manufacturers in the most recent PMI surveys, combined with increasing food prices and the rally in the oil price following the COVID-19-shock, inflation has bounced to 4.5%, above the central bank's target of 4%.

The central bank has until last week labelled the inflation bounce as transitory but is now indicating that the 'extraordinarily high degree of monetary stimulus … will be normalized.' Should this inflationary pressure persist, the central bank will have little option but to hike rates from the record low of 2%, tightening financial conditions and potentially derailing the fragile economy.

Indeed, the OIS curve implies that the central bank will have no choice but to raise rates significantly, pricing in 225bps of hikes over the course of 2021 (see Exhibit 5). This indicates that investors believe the spending cap will be abandoned causing a further rise in bond yields due to fiscal uncertainty or that inflation will force the central bank's hand.

Exhibit 5: Overnight Index Swap Implied Policy Rate Curve



Source: Bloomberg

While markets seem to be pricing in either stimulus or inflation, there are other possible outcomes. If inflation were to prove transitory, the government may return to the fiscal norm, allowing low central bank rates and structural reform to do the heavy economic lifting, at the same time privatisations could reduce debt to GDP.

The recovery could be aided by Brazil's well-developed, five-decade-old immunisation program, which operates 35,000 outposts and could distribute vaccines as they become available in the first half of 2021. This approach would please fiscal hawk and Economic Minister Paulo Guedes, a big proponent of privatisation and reform. Administrative and tax reform would be the best place to start after pension reforms were passed in 2020.

If inflation were to persist, Bolsonaro could maintain stimulus, and pressure the central bank to start QE. If the bank were to target a yield below the nominal growth rate, this would reduce the government's debt burden over time. QE would cause this non-reserve currency to depreciate even further and would endanger Brazil's credit rating, but ultimately lead to a lower debt burden.

Conclusion

We will continue to keep a watchful eye on Brazil's economic and political developments. As highlighted, fiscal discipline appears uncertain given upcoming elections, and we are seeing green shoots of inflation. This is reflected in rising bond yields, a weak currency and the OIS curve.

Brazil remains in our 'least-preferred' category when it comes to setting our cost of capital. Consequently, we use higher discount rates for Brazilian companies when forecasting future cash flows. The result is that Brazilian companies must be truly exceptional and offer strong free-cash-flows to warrant investment for Northcape.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au

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