Brazil's Economic Reforms

A number of business-friendly reforms against an improving economic backdrop have likely contributed to Brazilian equities surpassing their Emerging Markets (EM) peers this year (see Exhibit 1 for timeline and further details). With additional beneficial measures planned and pervasive skepticism about their chances of passage, we think more positive surprise may await and remain optimistic of Brazil's prospects. In our view, Brazil's experience underscores how economic reforms can lift equities, particularly in the many EM countries where positive reform is badly needed.

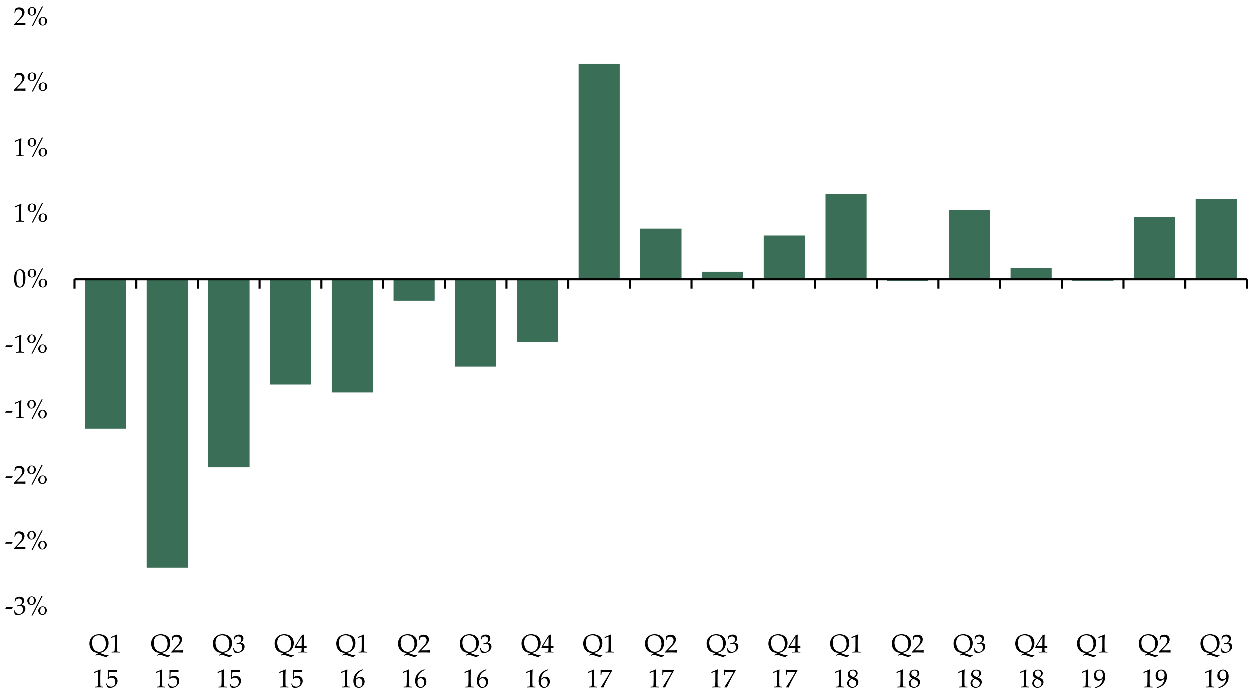
Exhibit 1: Timeline of Recent Events

Date	Details	Commentary
12/11/2019	Bolsonaro leaves Social Liberal Party (PSL) and creates "Alliance for Brazil"	He expects to attract 31/53 PSL deputies, making his party a key player in congress, but potentially weakening his base overall.
5/11/2019	Administration introduces new reform proposals	Focus remains on economic reform efforts and improving fiscal stability. Tax reform to come later.
23/10/2019	Brazil Senate passes Pension Reform	The landmark reform was passed in 6 rounds of voting that started in February. The primary bill is expected to save R$ 800 trillion over 10 years, with unpassed parallel bills potentially adding another R$ 95 trillion.
22/8/2019	Bolsonaro announced plan to speed up privatisation of state-owned companies by the end of his term	A continuation of the centerpiece of Bolsonaro's economic policy and efforts to boost the private sector. The privatisation of any state-owned company will require congressional approval, and state development bank BNDES is in charge of feasibility studies.
29/7/2019	Government preparing tax reform	With pension reform more certain, congress has put forth several tax proposals, most of them proposing a reduction in taxes and simplification of the system. The latter should improve the business environment with a reduction in compliance costs.

Source: Fisher Investments Research

After a two-year recession that ended in Q1 2017, Brazil seemingly struggled to find its stride amid lingering political scandals and tepid GDP growth. 2019 has been kinder, though: GDP growth accelerated in Q2 and Q3 (Exhibit 2).[i] While backward-looking, the data suggest Brazil's economy may be on firmer economic footing.

Exhibit 2: Brazilian Real GDP Growth – Q/Q (in percent)



Source: FactSet, as of 12/10/2019. Seasonally adjusted quarter-over-quarter percentage change in Brazilian GDP, Q2 and Q3 2019.

The biggest surprise out of Brazil this year, however, has been the government's economic reform progress. Right-wing legislator Jair Bolsonaro took office on 1 January promising major changes to make Brazil more business-friendly, privatise some of Brazil's largest state owned assets, and open up opportunities for outside investors, which many considered unlikely, partly because of political gridlock.

Brazil's Congress contains over 30 parties, and his (now-former) Social Liberal Party holds just 53 of 513 seats in the lower house and 2 of 81 seats in the upper. He left the party to start his own party in November due to disagreements with party leadership. Navigating a fractured legislature generally requires diplomacy. President Bolsonaro's reputation for bombast and often challenging relationship with Congress had many pundits thinking diplomacy wouldn't materialise.

But in October, lawmakers approved changes to Brazil's bloated pension system. Prior governments had tried and failed to overhaul it for three decades, fearing blowback from beneficiaries reluctant to give up generous benefits. Meanwhile, the system's fiscal burden expanded heavily, eventually soaking up 45% of the federal budget while remaining substantially underfunded.[ii] While the reform won't fix Brazil's finances overnight, it should help. By raising the retirement age and dialing back benefits, the government projects it will save nearly $200 billion over 10 years.[iii] Passage also signaled the administration is willing and able to follow through on difficult reforms—and, equally important, that Brazil's Congress can muster agreement on controversial legislation.

Beyond pensions, the administration—under the guidance of Economy Minister Paulo Guedes—has implemented several other business-friendly changes. These include tariff cuts, signing a (not yet ratified) trade deal with the EU, privatizing state-owned assets and firms (including utility giant Eletrobras), and easing restrictions on starting and running a business.

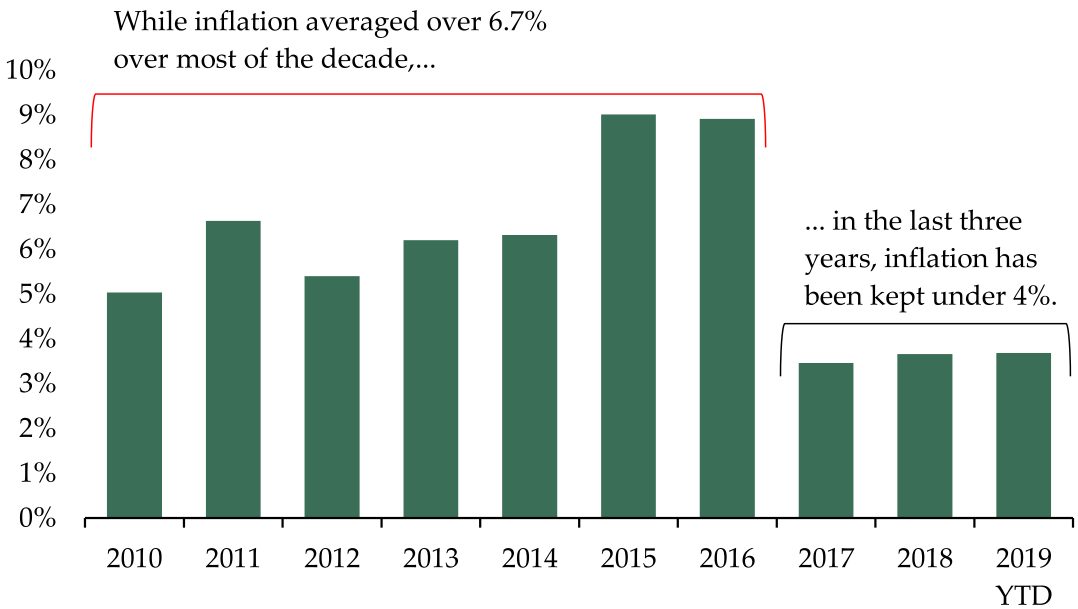
Markets have seemingly applauded said changes. Year to date, the MSCI Brazil Index has outperformed the MSCI EM.[iv] Brazil's advantage over EM comes despite a -4.4% November dip—likely a case of investors selling the news of pension reform's passage after buying in the run-up.[v] In our view, Brazil's outsized 2019 gains show a pro-reform political environment can be a bullish force for equities in less economically competitive nations, which are more prevalent in Emerging and Frontier Markets. Many EMs have significant barriers to trade, investment and doing business generally. Since markets are accustomed to these negatives, they often rise despite them. But when an EM country presses on with meaningful reforms, markets often respond positively. A similar process played out in recent years in Indonesia, Mexico and India following the election of reformist candidates.

While many seemingly understand reforms are the swing factor for Brazilian equities, sentiment is still guarded. Many fear pension reform has exhausted President Bolsonaro's political capital and don't expect much more progress. Yet the administration has several more policies in its sights, including trimming government expenditures and improving their efficiency, simplifying the tax code, reducing the federal workforce, cutting more tariffs and privatizing more state-owned firms and assets. We believe this is an ambitious agenda, and we are not saying all of it will come to fruition. But we think the agenda has a better chance than many currently expect, increasing the potential for positive surprise.

Recent Economic Indicators

More economic growth would likely sustain the administration's political capital and give Congress breathing room to pass measures that wouldn't pass when the economy was weak and voters craved stimulus. On this front, Brazil's economic backdrop looks promising. Inflation is low, averaging just 3.7% year to date (through November) compared to 8.9% in 2015 – 2016 (Exhibit 3).[vi]

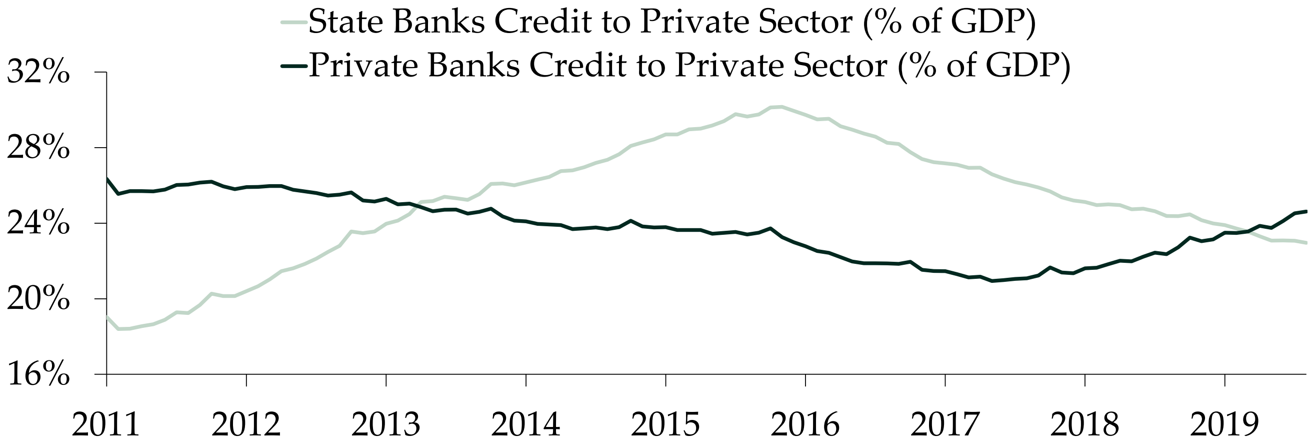
Exhibit 3: Brazilian Inflation – Year-over-Year



Source: FactSet. Average year-over-year change in Brazilian consumer prices.

Such benign inflationary expectations, has given the central bank flexibility to loosen monetary policy significantly, bringing rates to an all-time low of 4.5%. In total, the bank reduced rates 9.75% since the easing cycle began October 2016.[vii] This policy has helped narrow the spread between state owned bank and private sector bank lending rates, allowing private sector banks to regain market share (Exhibit 4).

Exhibit 4: Credit to Private Sector



Source: Banco Central do Brasil, as of October 2019.

Benign inflation also means that the central bank doesn't need to tap the breaks while credit growth to non-financial corporations and households is accelerating, most recently notching 6.6% y/y in October.[viii] Abundant capital should support domestic demand. Meanwhile, although Brazil's exports have been declining this year, the ongoing global expansion likely means steady demand for Brazil's exports—important in a trade-heavy country. All this suggests to us investors are underrating the probability of continued growth facilitating more beneficial reforms—potentially setting up further gains for Brazilian equities.

[i] Source: FactSet, as of 10/12/2019. Quarter-over-quarter percentage change in Brazilian GDP, Q2 and Q3 2019.
[ii] "Brazil Senators Approve Pension System Overhaul," Paulo Trevisani and Jeffrey T. Lewis, The Wall Street Journal, 10/22/2019. https://www.wsj.com/articles/brazil-senators-approve-pension-system-overhaul-11571786238
[iii] "Brazil pensions: Victory for Jair Bolsonaro as reform passes," BBC, 10/24/2019. https://www.bbc.com/news/world-latin-america-50151327
[iv] Source: FactSet, as of 12/12/2019. MSCI Emerging Markets Index and MSCI Brazil Index returns with net dividends in USD, 31/12/2018 – 11/12/2019.
[v] Ibid. MSCI Brazil Index returns with net dividends in USD, 31/10/2019 – 29/11/2019.
[vi] Ibid., as of 11/12/2019. Average year-over-year change in Brazilian consumer prices, January 2019 – November 2019 and January 2015 – December 2016.
[vii] Source: Factset, as of 12/18/19.
[viii] Source: Banco Central do Brasil, as of 11/12/2019. Year-over-year percentage change in total credit to the non-financial sector, October 2019.

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