BIENVILLE GLOBAL REVIEW

Brazil: Mounting Imbalances Require Political Will

April 2015

Brazil: Mounting Imbalances Require Political Will

Summary

In U.S. dollar terms, Brazilian equities have fallen 60% since 2010. In our October 2013 review, *Brazil: In Need of a New Growth Model,* we highlighted a number of economic adjustments needed in Brazil. Since then, the imbalances have metastasized, requiring even more political will to resolve them. But with last year's re-election of Dilma Rousseff, who is currently embroiled in scandal, the orchestration of a necessary but painful adjustment process seems like fantasy. Investors should remain cautious.

- Brazil's key economic variables have continued to deteriorate over the past 18 months. Weak growth has given way to recession while inflation has increased to 8.1%, well above the central bank's target range.
- Policymakers face a difficult tradeoff between restoring growth and taming inflation. Supply-side bottlenecks, a weakening currency and increased regulated prices are driving inflation. Higher interest rates may not be enough to reduce inflation, but would surely exacerbate the downtrend in growth, as would needed fiscal tightening. There is no easy way out.
- With gross public debt now 64% of GDP, and a fiscal deficit of 7%, Brazil's investment grade credit rating is in jeopardy.
- The Brazilian outlook faces other downside risks. For example, given the severity of the country's drought, water and power rationing could continue for two or three more years. High household debt is another complicating factor. Reducing debt either through repayments or write-downs will hamper growth, but the latter would create stress in the banking sector, putting additional pressure on asset prices.
- With more than three years remaining in her second term, Dilma is facing an increasingly confrontational Congress, largely due to the Petrobas scandal. Scandal-plagued governments don't often engineer unpopular economic adjustments. Reform is therefore likely to be delayed until the next administration in 2018. Such a scenario could disappoint the market further, encouraging capital flight and creating additional pressure on Brazil's currency.
- Although negative sentiment may produce another tradable bounce in Brazilian assets, more time is likely needed before a medium-term opportunity presents itself. Unique opportunities aside, neither the currency, nor the equity market are cheap.

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In our October 2013 Bienville Global Review, *Brazil: In Need of a New Growth Model*, we wrote: *"Brazil's growth model has been exhausted, and a difficult adjustment process is necessary. Disappointingly, the political will for reform remains conspicuously absent."* Despite the passage of almost 18 months, the adjustment process has been avoided while fundamentals have deteriorated, increasing the need for structural reforms...

Economic Variable	October 2013 Situation	Current Assessment
Growth	Stagnating, downside risks	Economy in recession, no clear growth catalysts
Inflation	At high levels (6.4%)	Now at 8.1%, above the central bank target, and could go higher
Public Debt	Low net debt masked rising gross debt levels	Rising debt levels could lead to a sovereign downgrade as gross debt levels exceed 64% of GDP
Private Debt	In need of deleveraging	Potential for difficult nonperforming loan cycle
External Accounts	Current account deficit of 3.9% of GDP	Current account deficit widening to 4.5% of GDP. External debt stock approaching $600bn
Currency	*Real* clearly overvalued (2.2 per USD), businesses uncompetitive	Currency has devalued 40%, now closer to fair valuation (3.1 per USD), but downside risks remain
Investment	Brazil is underinvesting	Investment has continued to fall (-10.0% YoY)

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Brazilian equities have fallen by 60% in U.S. dollar terms since peaking in 2010. Despite several short-term bounces, the downtrend is firmly established. Today, neither the currency nor the equity market are cheap, and major economic adjustments remain necessary…

MSCI Brazil Index

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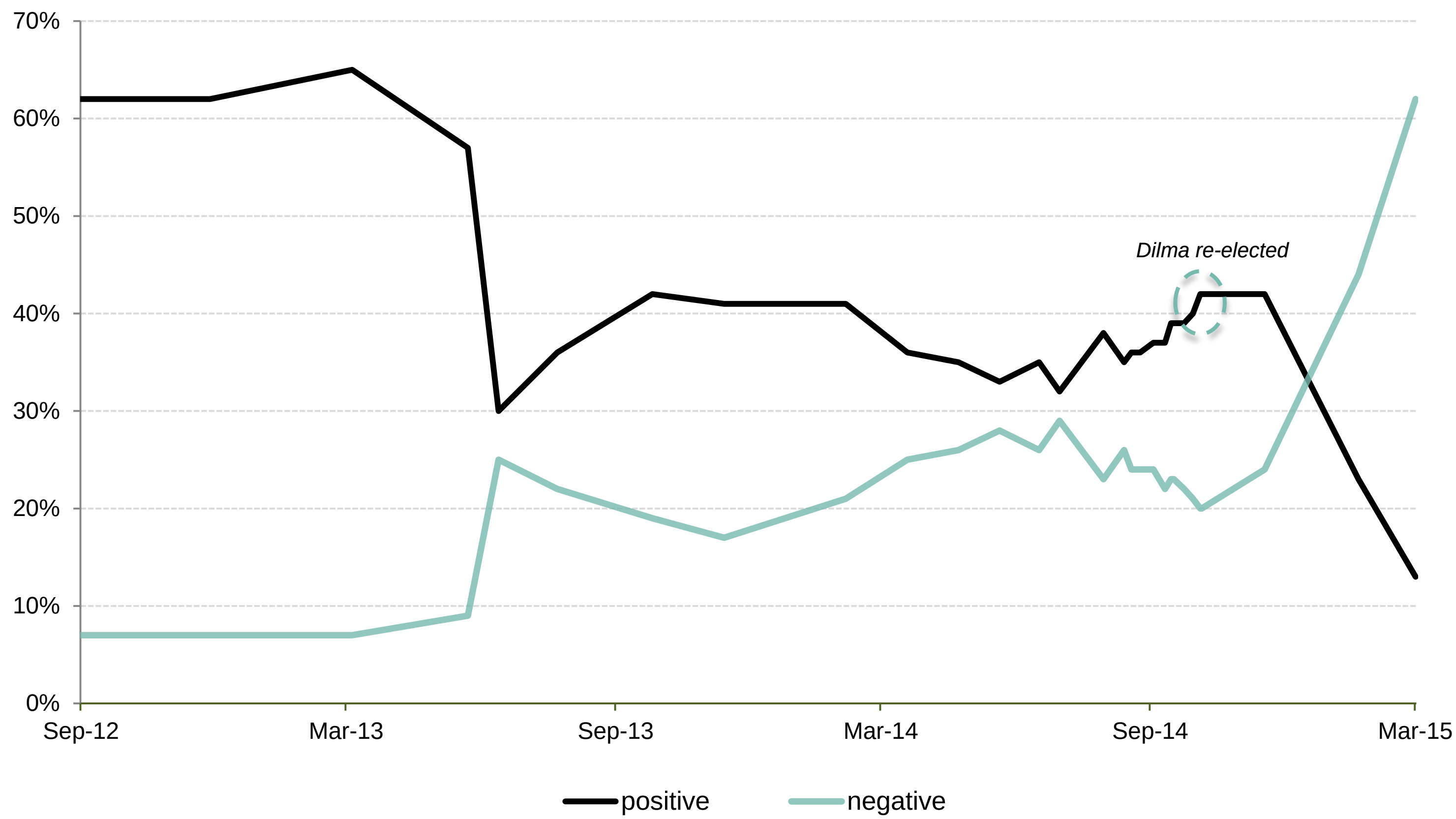
Since re-election in October 2014, President Dilma's approval rating has plummeted. Despite the political deterioration, she has refused to make changes to correct the faltering economy. Given her lack of effectiveness in managing the economy, Dilma is now losing support from the government, Congress and the public…

Dilma Rousseff Approval Ratings (%)



Source: Datafolha

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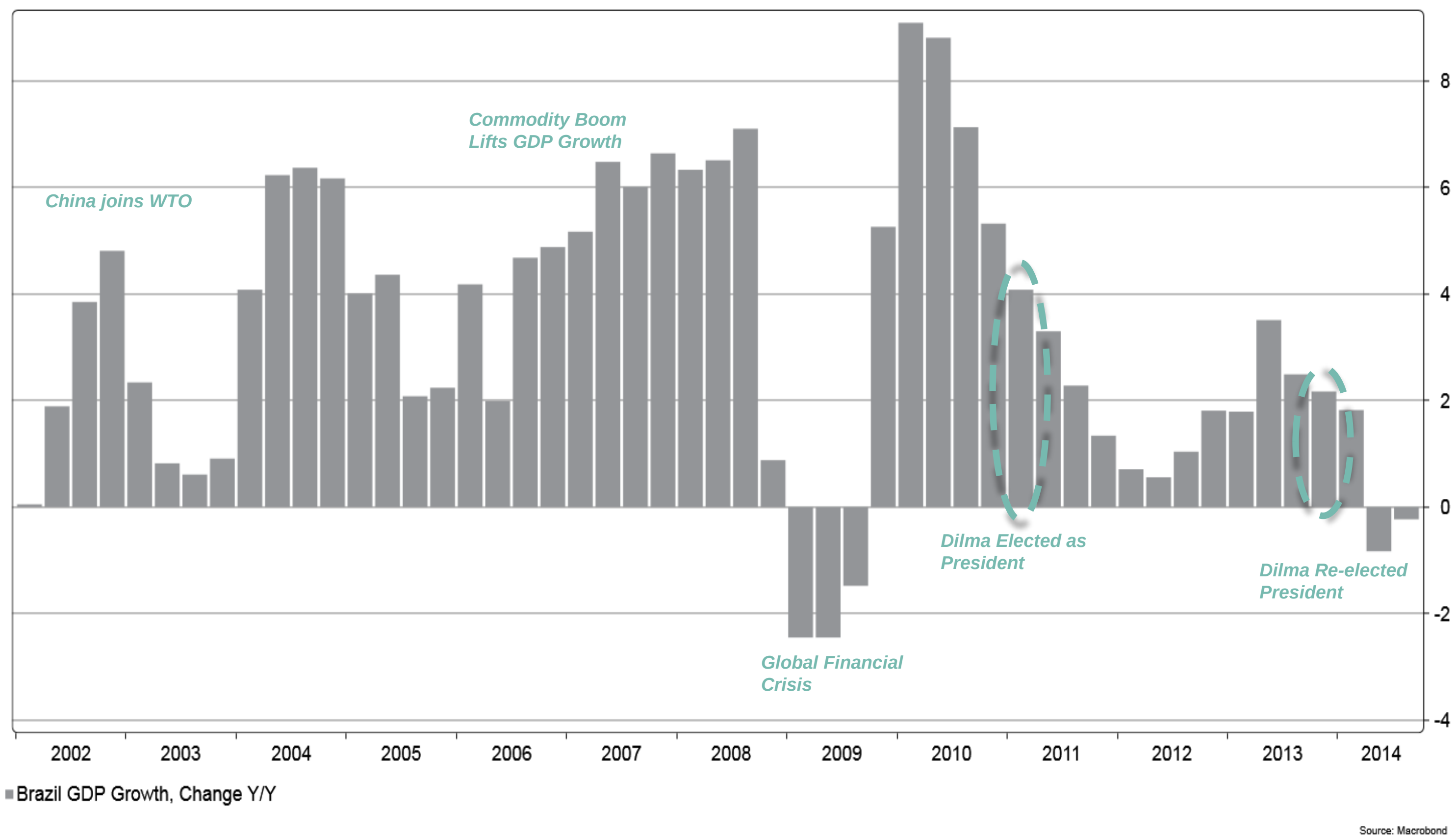
GDP has gone from stagnation to recession in the past year...

Brazil GDP Growth, % Change Y/Y



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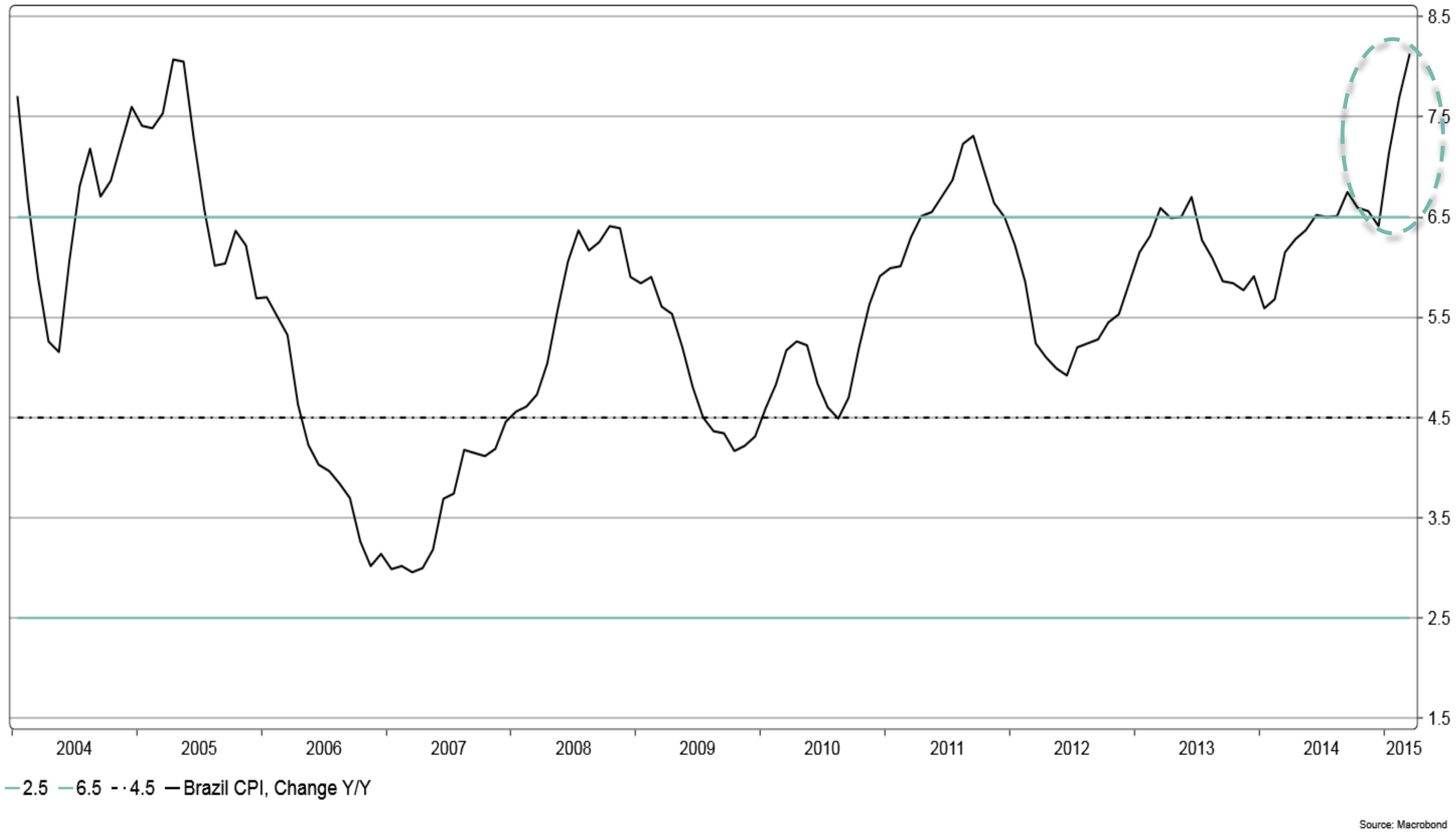
Inflation is well above the central bank's target range, set at 4.5% inflation +/-2.0%. In effect, the government has allowed the top end of the range to serve as the new target. Containing inflation will require additional monetary tightening…

Brazil CPI versus Central Bank Target Range



The central bank needs to tighten policy in order to contain inflation and restore credibility

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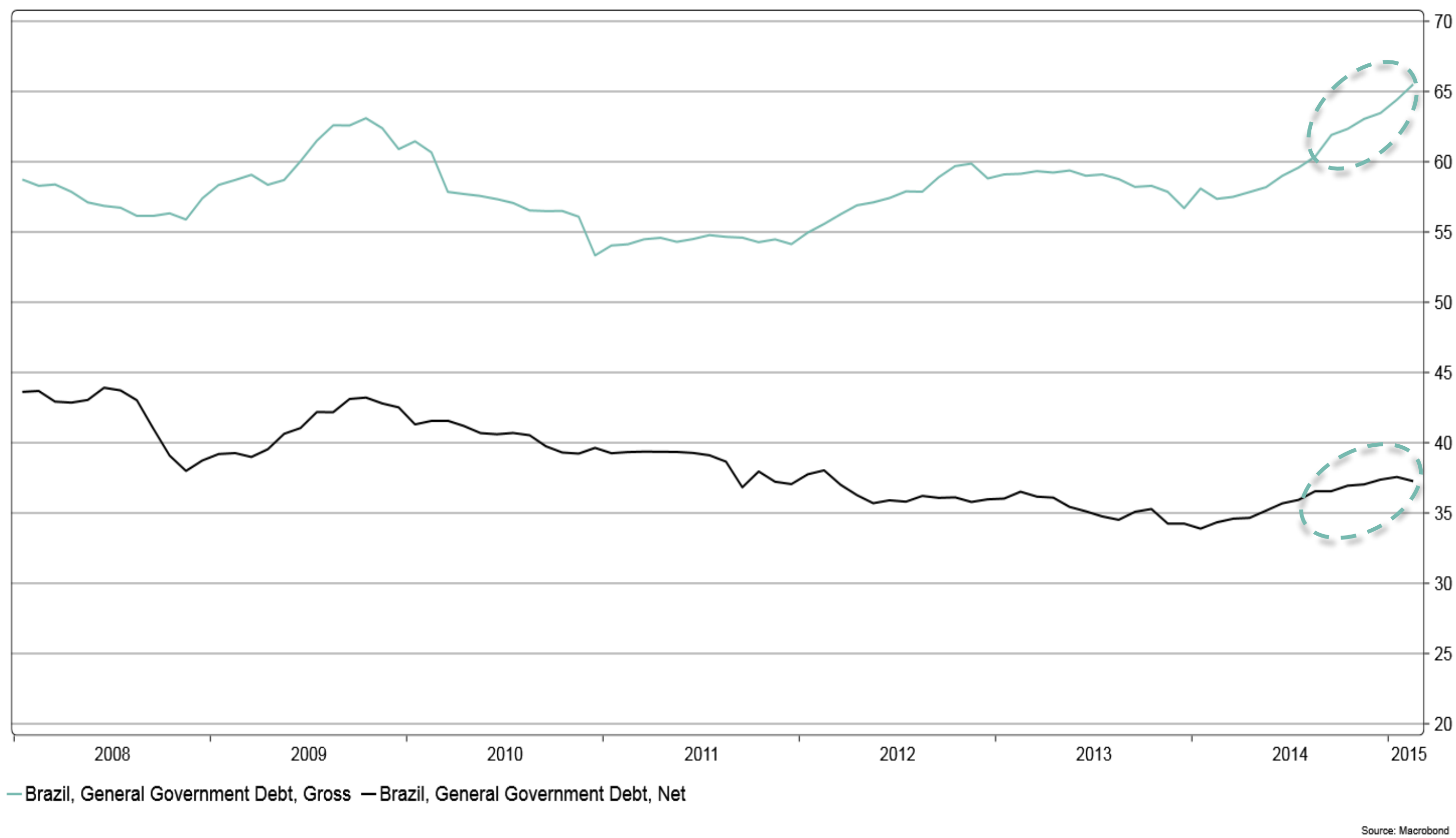
Gross government debt levels have continued to increase, while net debt has also begun to rise after years of declines. Rating agencies have warned of a downgrade…

Brazil Government Gross and Net Debt, % of GDP



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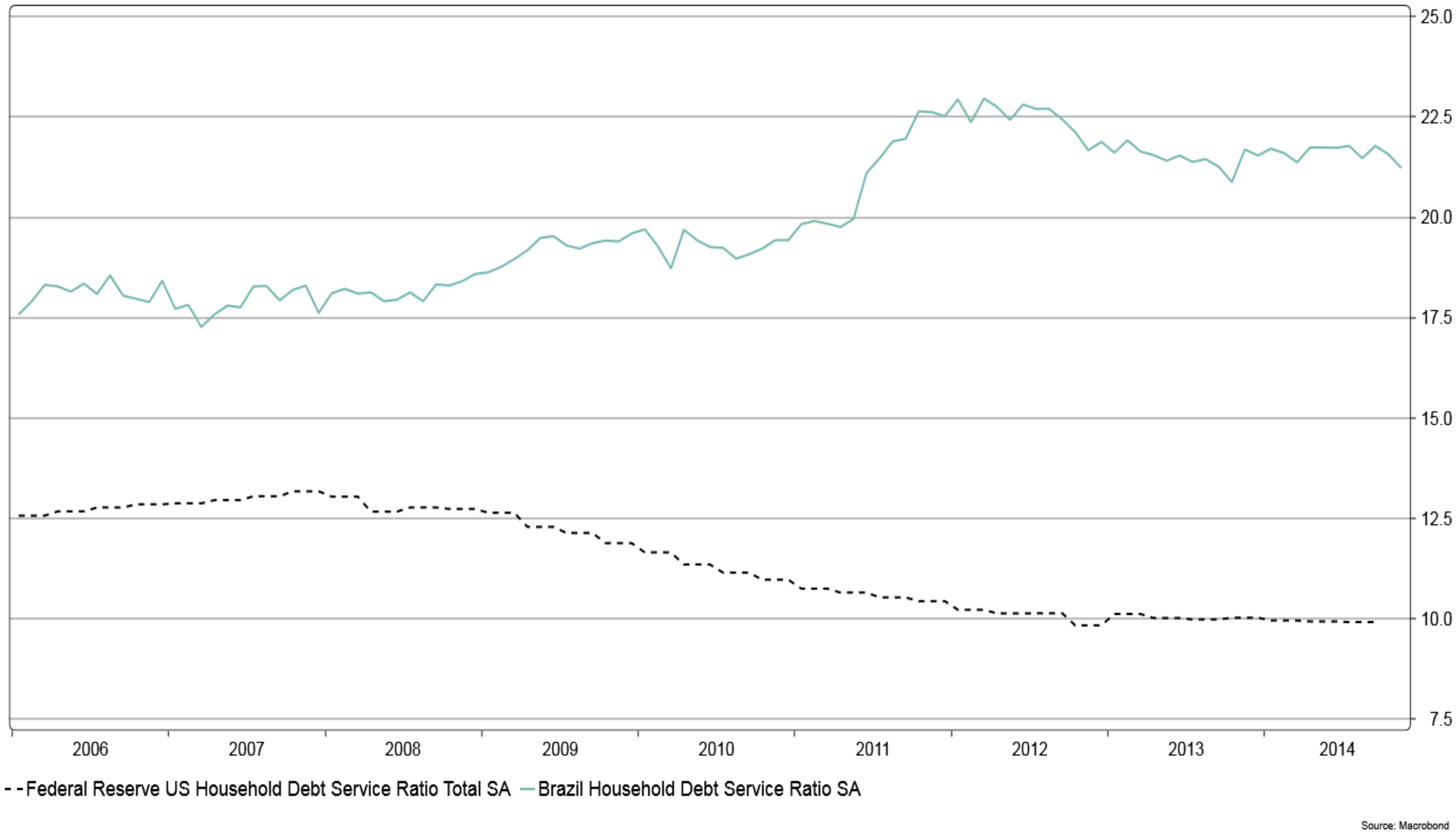
Brazil's household debt service ratio is higher today than during the boom years, and is far higher than what U.S. households amassed prior to the crisis and deleveraging that began in 2008. Brazilian households pay 21% of their income towards debt service at a time when real incomes are stagnating…

Household Debt Service Ratios, Brazil and U.S.



The U.S. debt service ratio peaked at 13% in 2007 (before the burst of the credit bubble) and has since come down below 10%

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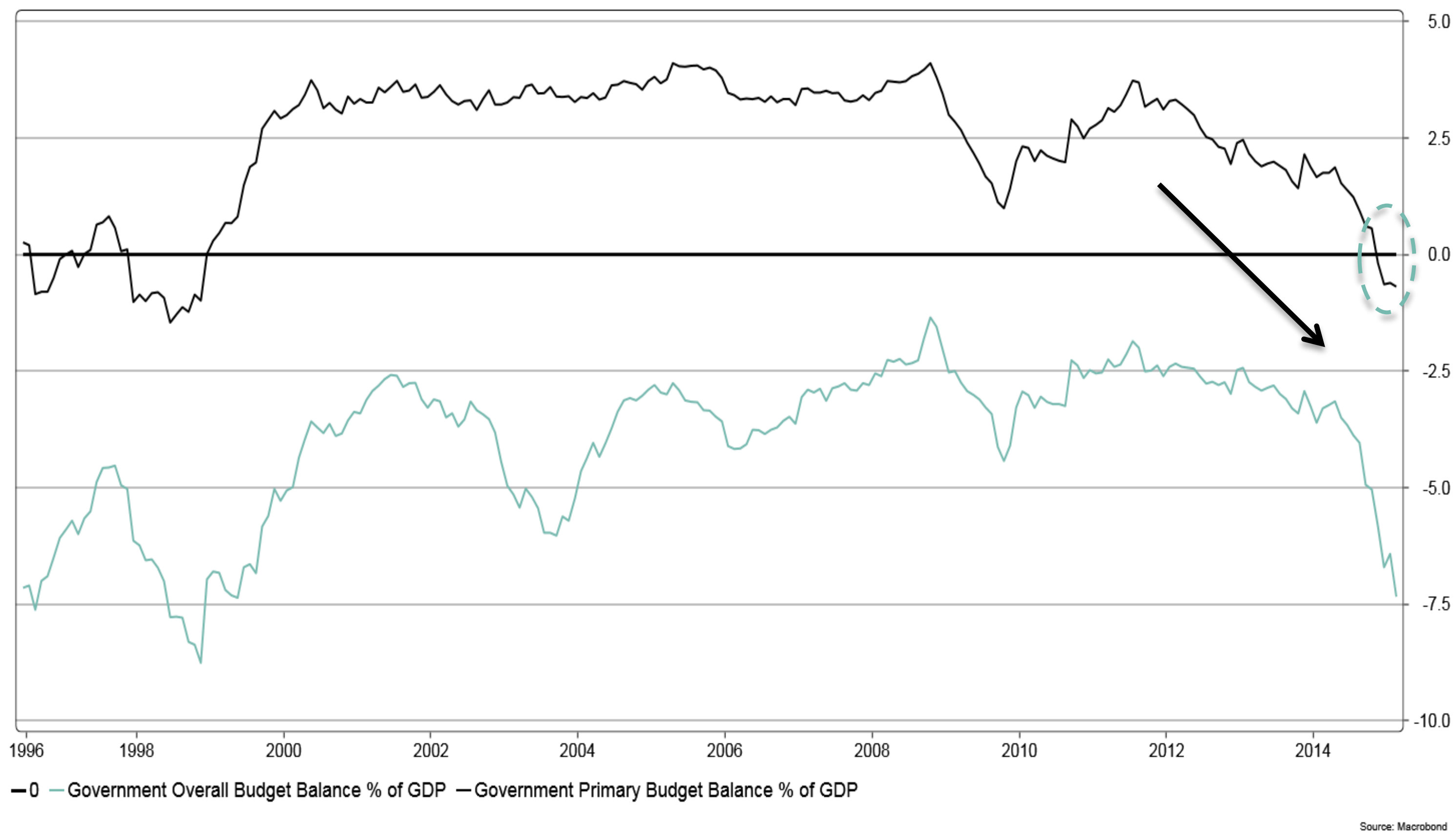
The current recession, combined with excessive spending during Dilma's push for re-election, has worsened Brazil's fiscal balances, reversing prior administrations' fiscal prudence. Today, Brazil no longer runs a primary surplus (i.e., budget surplus before interest payments). The deficit will deteriorate further if the government injects capital into Petrobras…

Brazil Government Primary and Overall Budget Balances



The recent announcement by Finance Minister Joaquim Levy to tighten spending by 1% of GDP seems far too little

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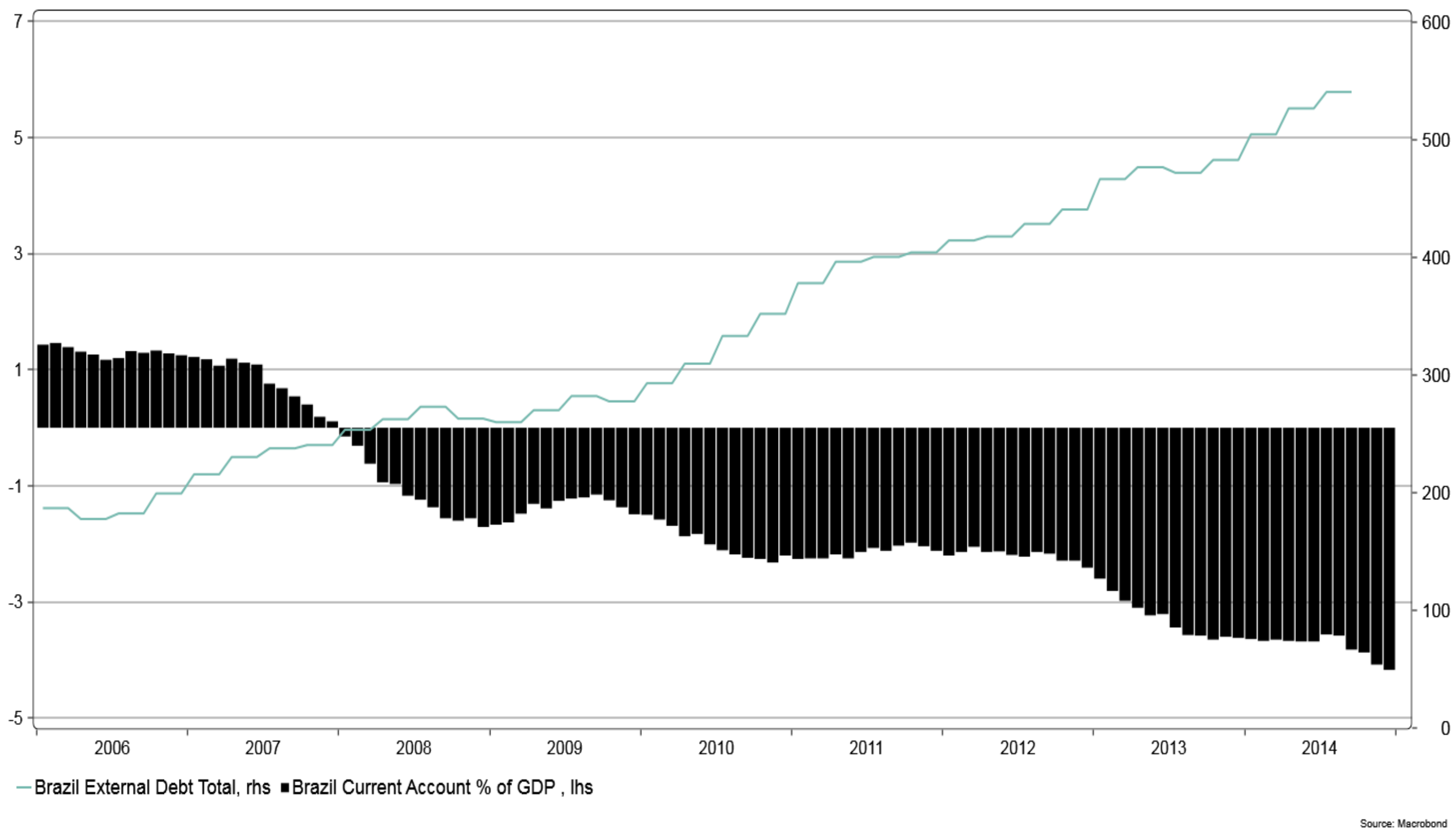
Persistent current account deficits since 2008 have increased Brazil's external debt to almost $600bn, or 25% of GDP. The recent reversal in foreign portfolio inflows could mean a sustained and painful deleveraging process…

Brazil Current Account Balance (% of GDP) vs Total External Debt ($)



Brazil's external debt has tripled in the past 5 years, far outpacing GDP growth

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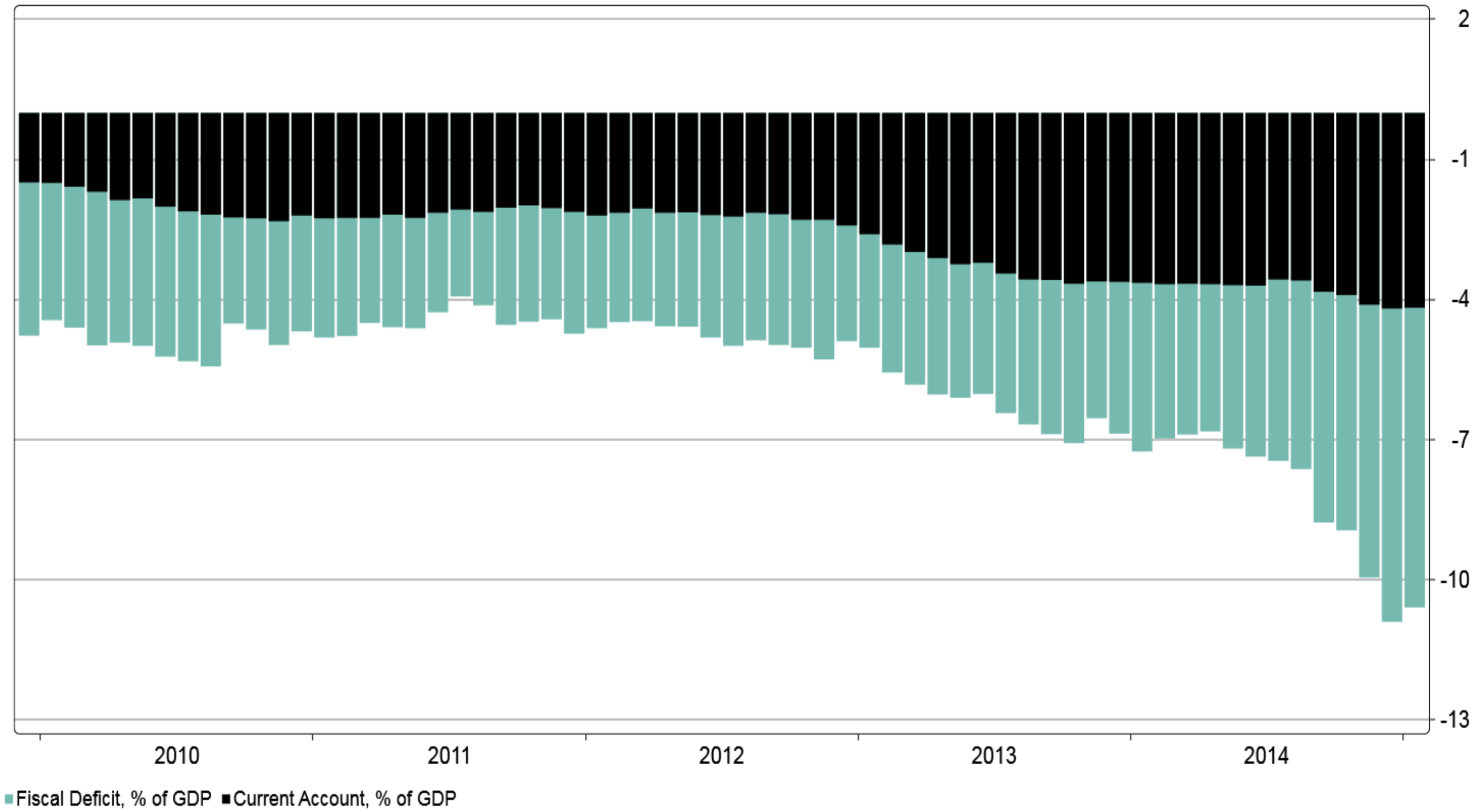
Rising current account and fiscal deficits have caused the "twin deficit" to widen to 11% of GDP, representing one of the major challenges for Dilma in her second term…

Brazil Current Account Balance (% of GDP) and Fiscal Deficit (% of GDP)



Source: Macrobond

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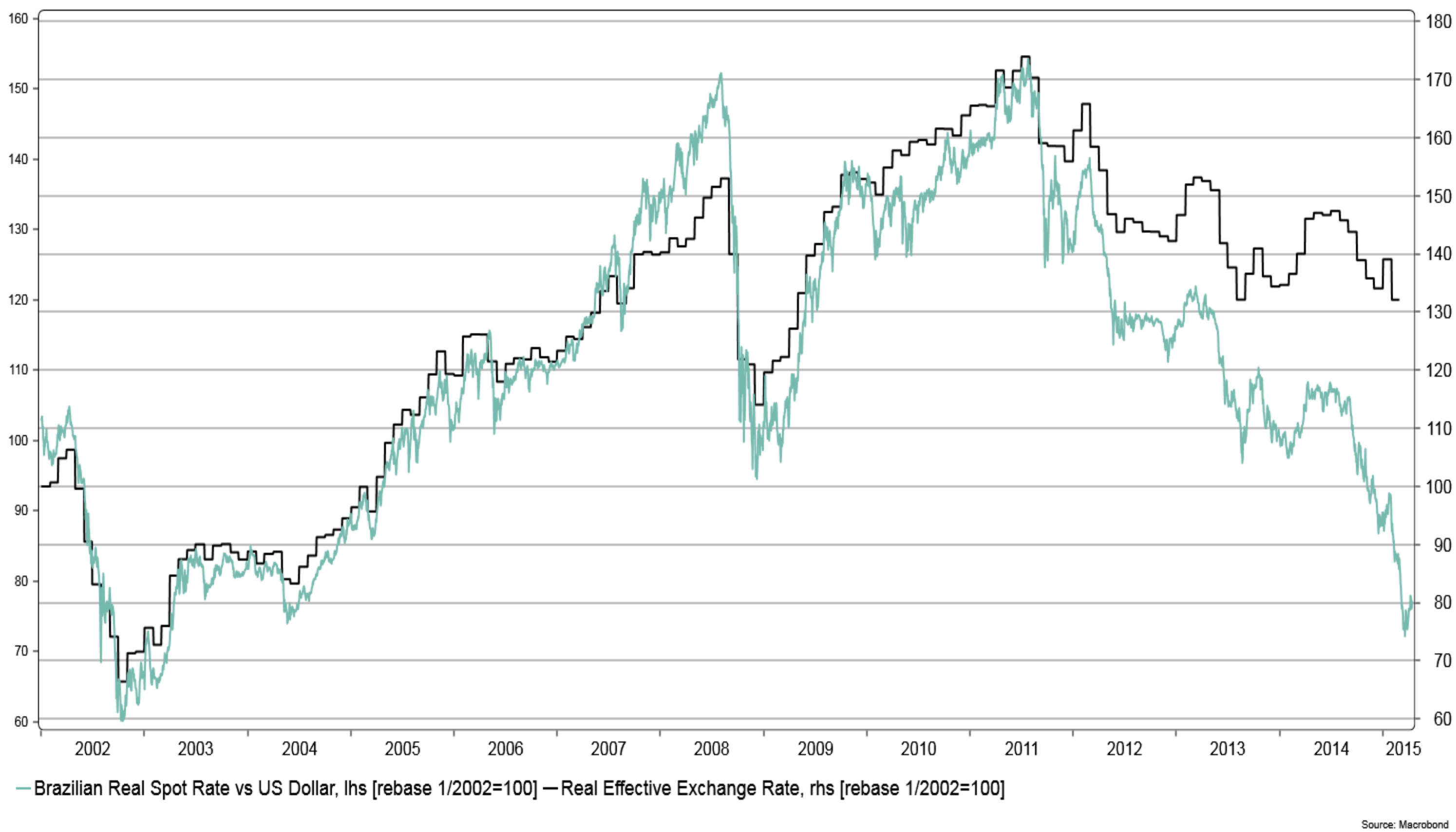
Although the nominal value of the Brazilian currency has fallen to the lowest level against the U.S. dollar in years, high inflation has left the real effective exchange rate at levels that are still uncompetitive…

Brazilian *Real* - Real Effective Exchange Rate versus Spot Rate



The Real Effective Exchange Rate (REER), a trade-weighted and inflation-adjusted rate, has not depreciated as much as the nominal exchange rate vs the U.S. dollar

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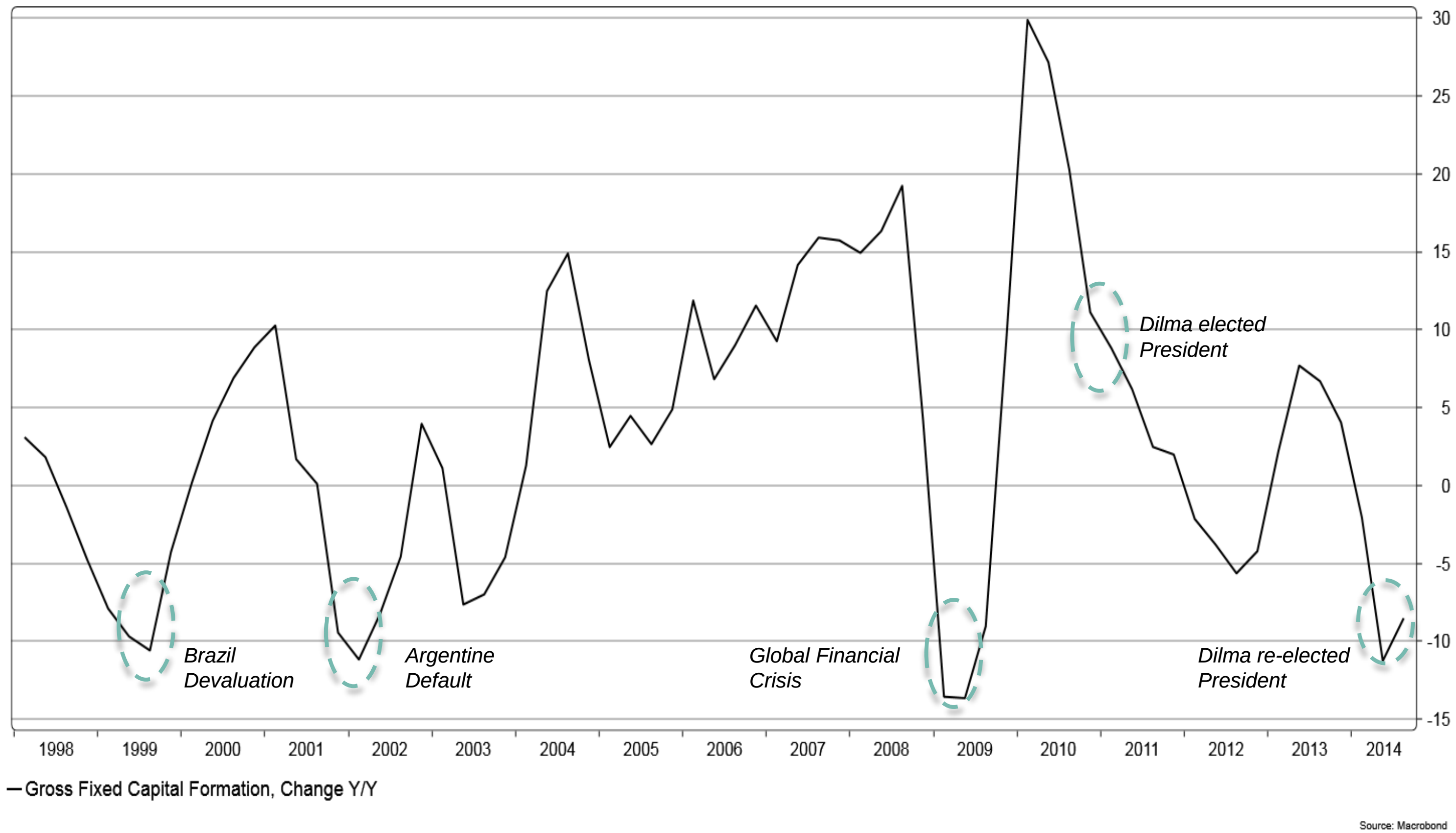
Dilma has been hostile to investment, causing fixed capital formation to fall to levels typically associated with crisis (e.g., Global Financial Crisis, Argentine default, Brazil devaluation). The ongoing investigation into Petrobras has paralyzed infrastructure and construction spending. Private investment could remain depressed for some time…

Brazil Gross Fixed Capital Formation, % Change Y/Y



Dilma's administration is notorious for allowing poor returns on capital for infrastructure and fixed asset investors. This has led to a continued decline of large scale investment projects in the country

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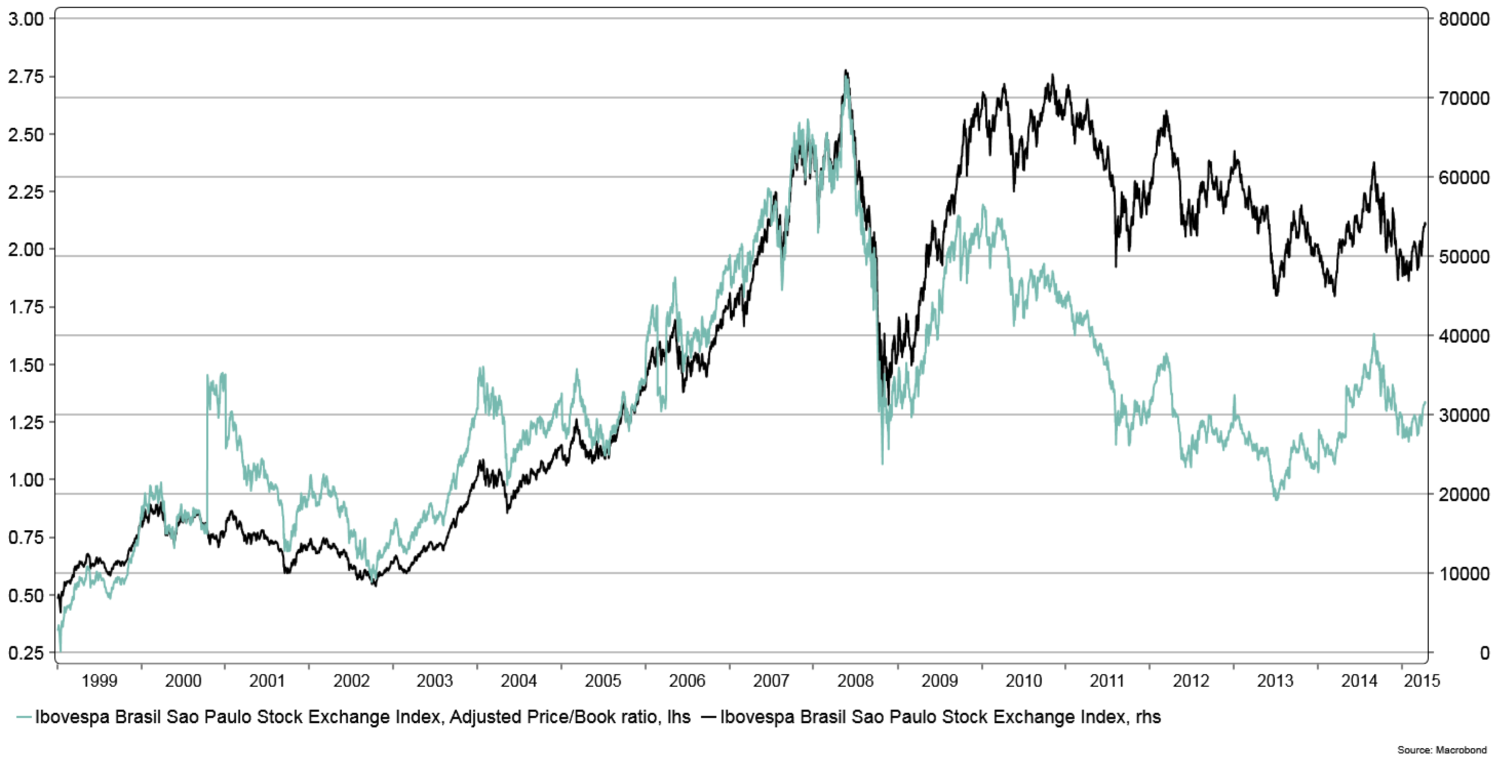
Despite a negative economic and political outlook, the Bovespa index is not particularly cheap. Today, the index trades at 1.3x book value, whereas historical lows have come at 1.0x book (or lower), suggesting additional downside risk to equities over the medium term…

Bovespa Stock Index versus Bovespa Price to Book Ratio



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