BIENVILLE GLOBAL REVIEW

Brazil: Approaching An Inflection Point

March 2016

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Summary

Brazil is in a political and economic crisis. Since Dilma's re-election in October 2014, asset prices have plummeted, the currency has devalued, and rising debt has driven bond yields higher. The administration is now embroiled in scandal, resulting in political stalemate. As conditions worsen, the probability of an early exit by Dilma rises, a first step to resolving Brazil's imbalances. But any marginal improvement in the political dynamics could short-circuit today's negative, reflexive feedback loop, catalyzing asset prices.

- Brazil is in a depression. Unemployment, inflation, and the fiscal deficit are all converging at 10%. Including 2016's expected GDP loss of 3.8%, the cumulative real economic contraction will also reach 10%, a stunning union of variables.

- Dilma's approval rating is currently below 10%. The PT, her political party, is embroiled in scandal and now fracturing. As a result, political stalemate is taking a severe toll on the economy. Collapsing confidence has led to a collapse in fixed investment.

- Dilma's populism is to blame. Rather than orienting the economy to sustainable sources of growth, she refused to acknowledge the end of the commodity boom, and pursued fiscal stimulus while also easing credit. The outcome has been disastrous—a negative feedback loop of rising debt leading to a weaker currency, inflation, and higher bond yields that have led to larger deficits, and so on.

- Although Dilma is ideologically opposed to changing course, she could soon be forced to. The 'Car Wash' scandal has reached former president Lula, who was recently detained. It seems likely Dilma will also be implicated. Sources suggest evidence against both is solid.

- Today's untenable situation could soon improve. Three avenues exist to remove Dilma prior to the conclusion of her mandate in 2018: (1) impeachment; (2) nullification of her re-election by the Electoral Supreme Court; and (3) resignation under pressure. Another possibility is Dilma remains President (and nominally in charge), but forced by the opposition to implement needed reforms.

- Since Dilma's re-election in October 2014, Brazilian assets have been crushed. In USD terms, equities fell 60%+ through February. The currency devalued 40%. Bond yields have risen to 15%. Investor sentiment is abysmal and locals are extraordinarily bearish.

- As seen in many other situations, a marginal improvement in politics may catalyze a substantial rally in assets. Lately, prices recovered some of their recent declines as optimism for regime change accelerated. If the PT departs, more upside is likely to come.

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Popular sentiment regarding Brazil has swung from euphoria to despair. Both cases will likely prove wrong.

November 2009

January 2016

Source: Economist

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Nonetheless, as highlighted in two of our previous reports, the decay over the past few years has been observable.

Economic Variable	October 2013 "Brazil: In Need Of A New Growth Model"	April 2015 "Brazil: Mounting Imbalances Require Political Will"	Current Assessment
Growth	"Stagnating, downside risks"	"Economy in recession, no clear growth catalysts"	Now in the worst recession since 1901
Inflation	"At high levels (6.4%)"	"Now at 8.1%, above the central bank target, and could go higher"	At 10.7%, the highest in 13 years
Public Debt	"Low net debt masked rising gross debt levels"	"Rising debt levels could lead to a sovereign downgrade"	S&P and Fitch have downgraded Brazil to junk. Budget deficit has widened to 10.8%
Private Debt	"In need of deleveraging"	"Potential for difficult nonperforming loan cycle"	Higher likelihood of NPL cycle if economic activity remains weak
External Accounts	"Current account deficit of 3.9% of GDP"	"Current account deficit widening to 4.5% of GDP"	Current account improving as FX adjusted, a positive
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"	*Real* has arguably overshot, reaching 4.2 per USD before strengthening modestly
Investment	"Brazil is underinvesting"	"Investment has continued to fall"	Investment has continued to be very weak

Source: Bienville Capital

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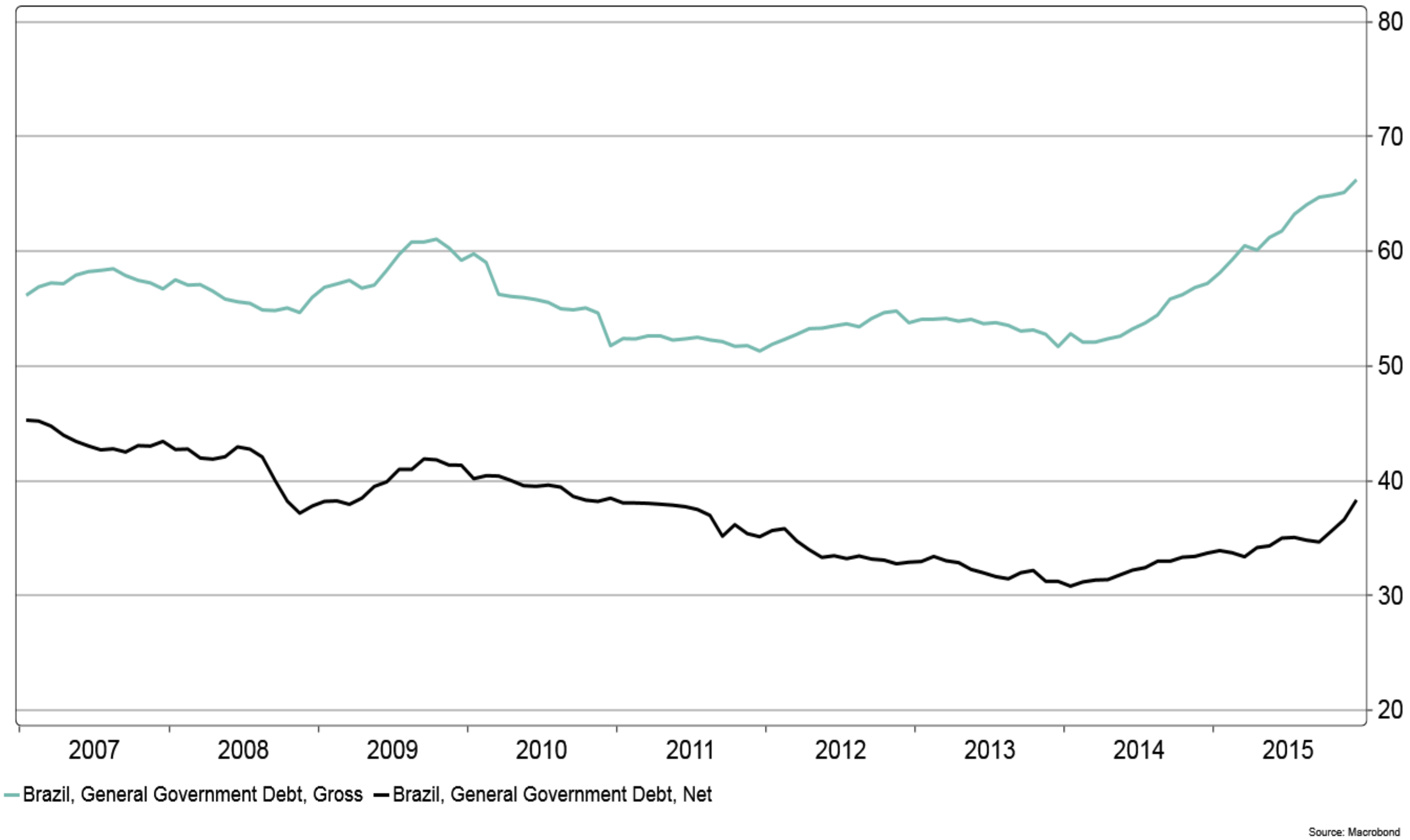
Rising annual fiscal deficits have led to a rising stock of debt…

Debt-to-GDP %



Source: Macrobond

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…which has led to rising interest rates. Two-year bond yields have doubled over the past four years at a time when major central banks are targeting negative policy rates.

2-Year Government Bond Yield %

Source: Macrobond

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The fiscal problems have contributed to the devaluation of Brazil's currency, the real.

USD/BRL Spot

Source: Macrobond

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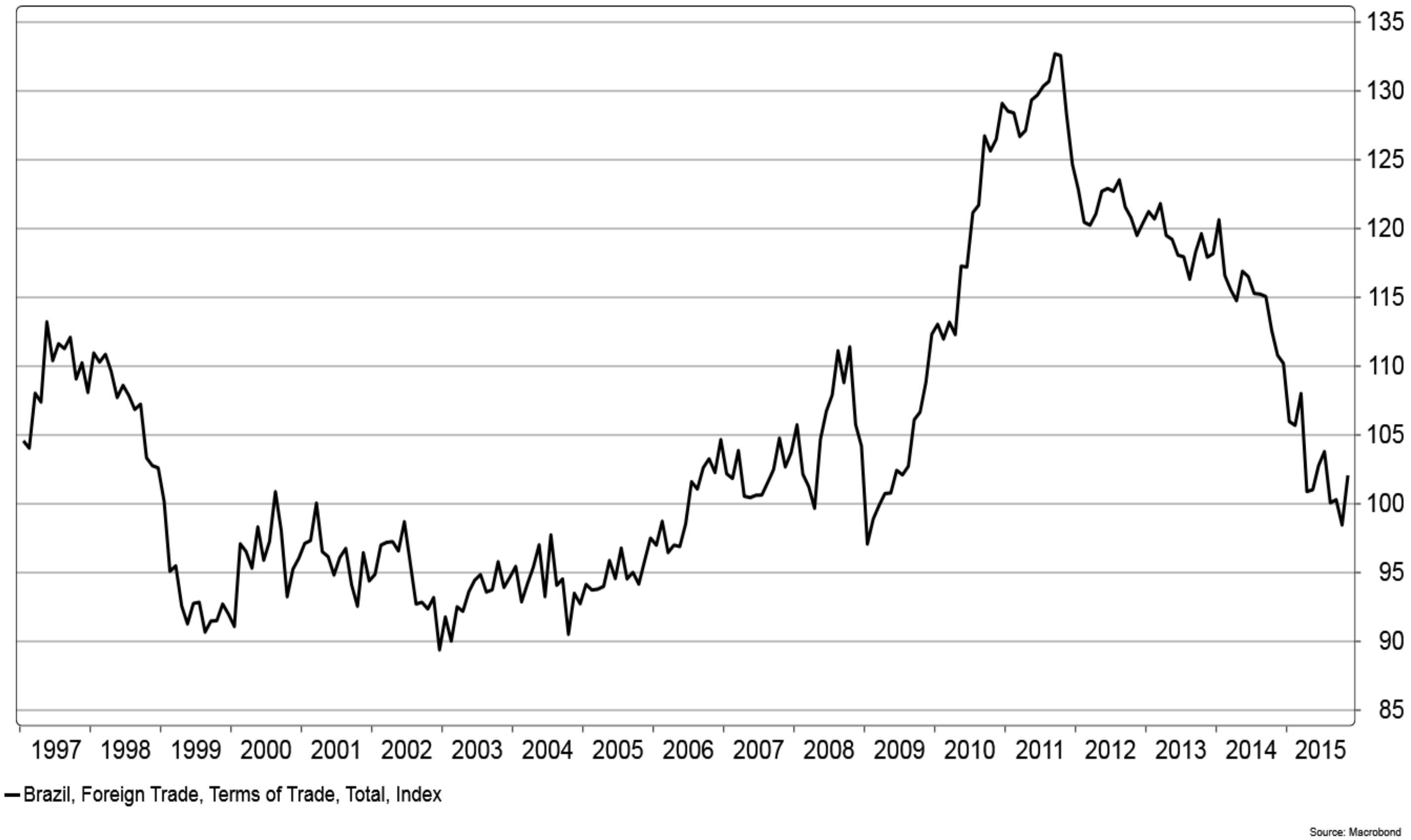
The deterioration in the terms of trade has also contributed to FX weakness. Although exports are only 10% of the economy, Brazil had previously benefited from high commodity prices.

Terms of Trade



Source: Macrobond

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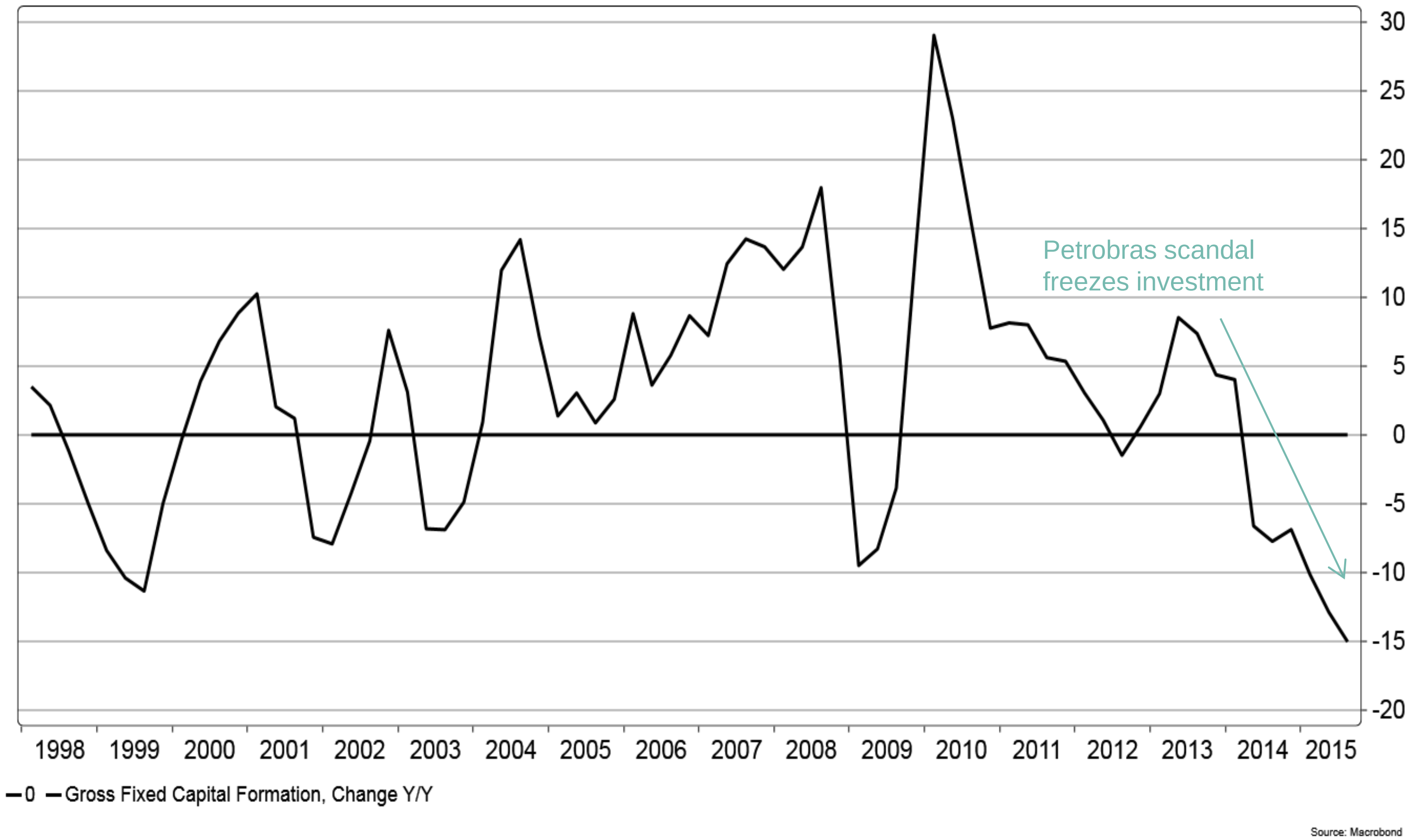
A weakening economy combined with political scandal has caused fixed investment to plunge, further weighing on economic growth.

Fixed Capital Formation



Source: Macrobond

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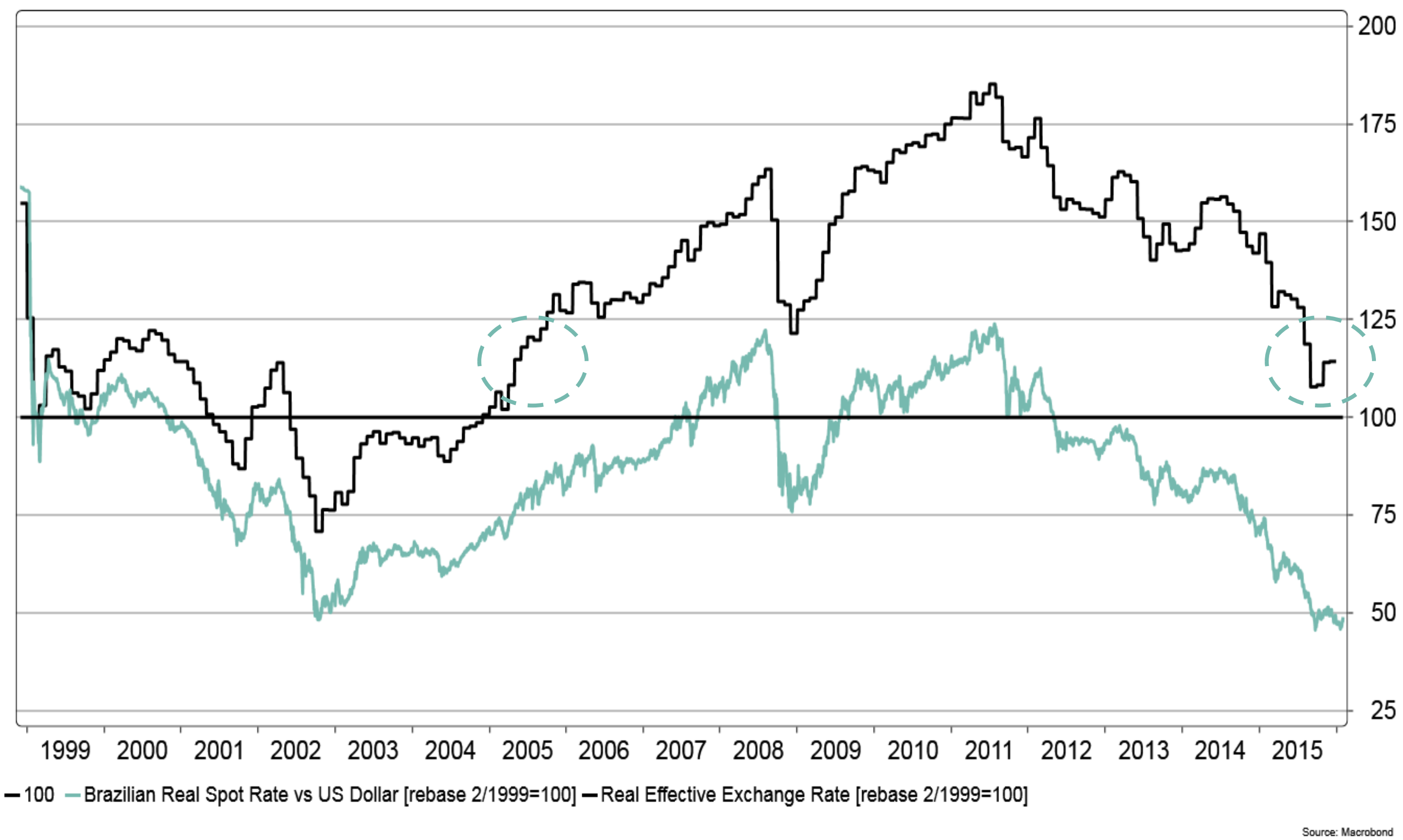
But the currency adjustment is beginning to provide some support to the economy, especially the external sector. On a real effective exchange rate basis, the BRL is back to 2005 levels…

Brazilian Real (BRL) | Nominal and Real Effective Exchange Rate



Source: Macrobond

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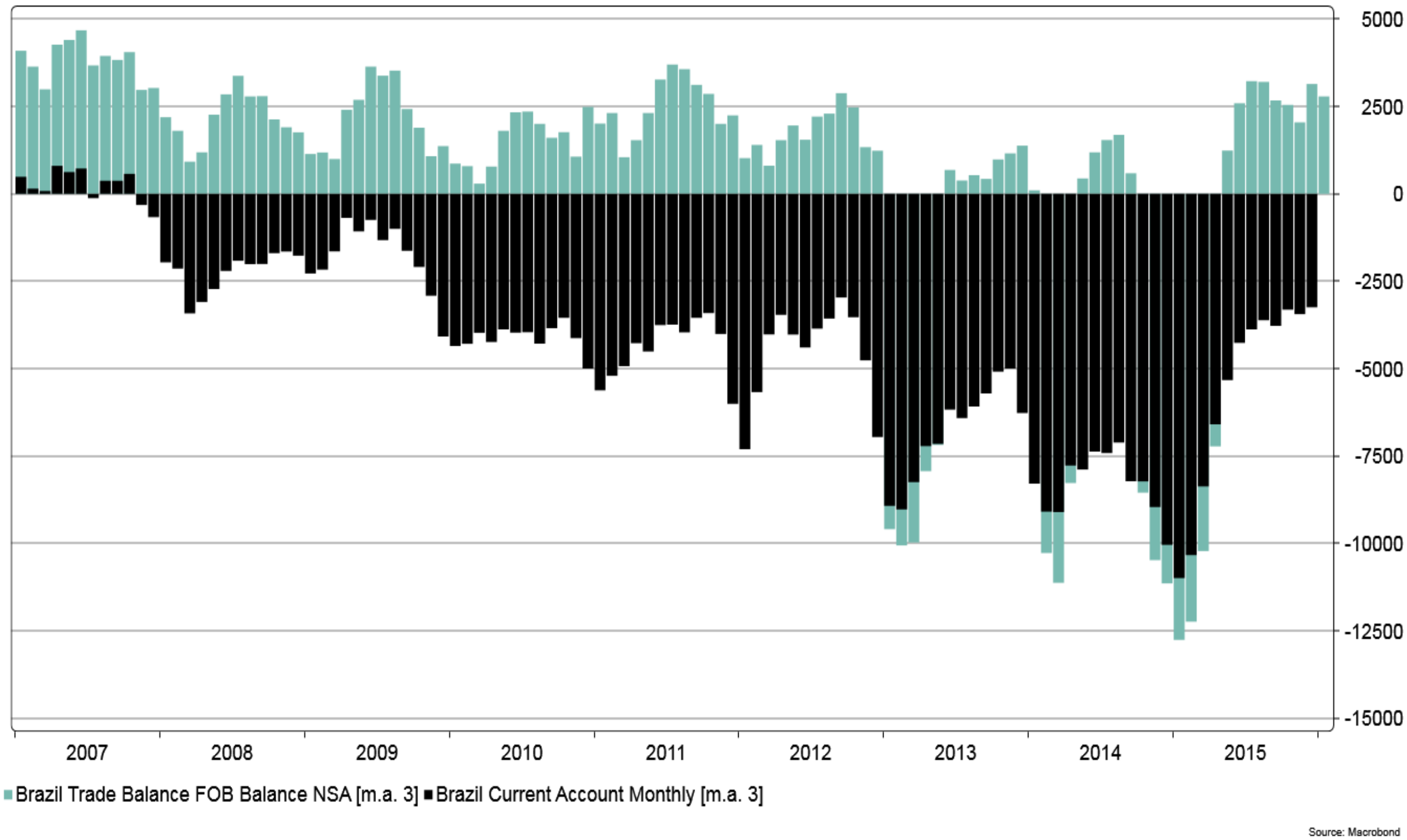
The currency adjustment is noticeable in Brazil's improving current account.

Brazil Current Account & Trade Balance



Source: Macrobond

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Once the political stalemate is ultimately resolved, there is ample room for structural reforms, many of which are supported by other political parties.

Reform	Potential For Improvement
Pensions	• End the indexation of pensions to the minimum wage
Tax Burden	• Brazil's tax burden is high relative to peers and compliance is expensive • Other parties have started various proposals to simplify and to lower the overall tax burden, which would help business investment
Investment	• Dilma depressed real returns on investment, partly by shifting regulations • The PSDB and PMDB have already articulated the desire to do a package of privatizations and new infrastructure concessions, with clearer regulations and attractive rates of return
Transfer Payments	• The PMDB has proposed that government spending, particularly automatic transfer payments, should grow below nominal GDP for a period of several years • This would take spending from the current unsustainable pace to balanced over the long run

Source: Bienville Capital

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Brazilian equities have been crushed, down by more than 60% since Dilma's re-election in October 2014.

MSCI Brazil Index (USD)

Source: Macrobond

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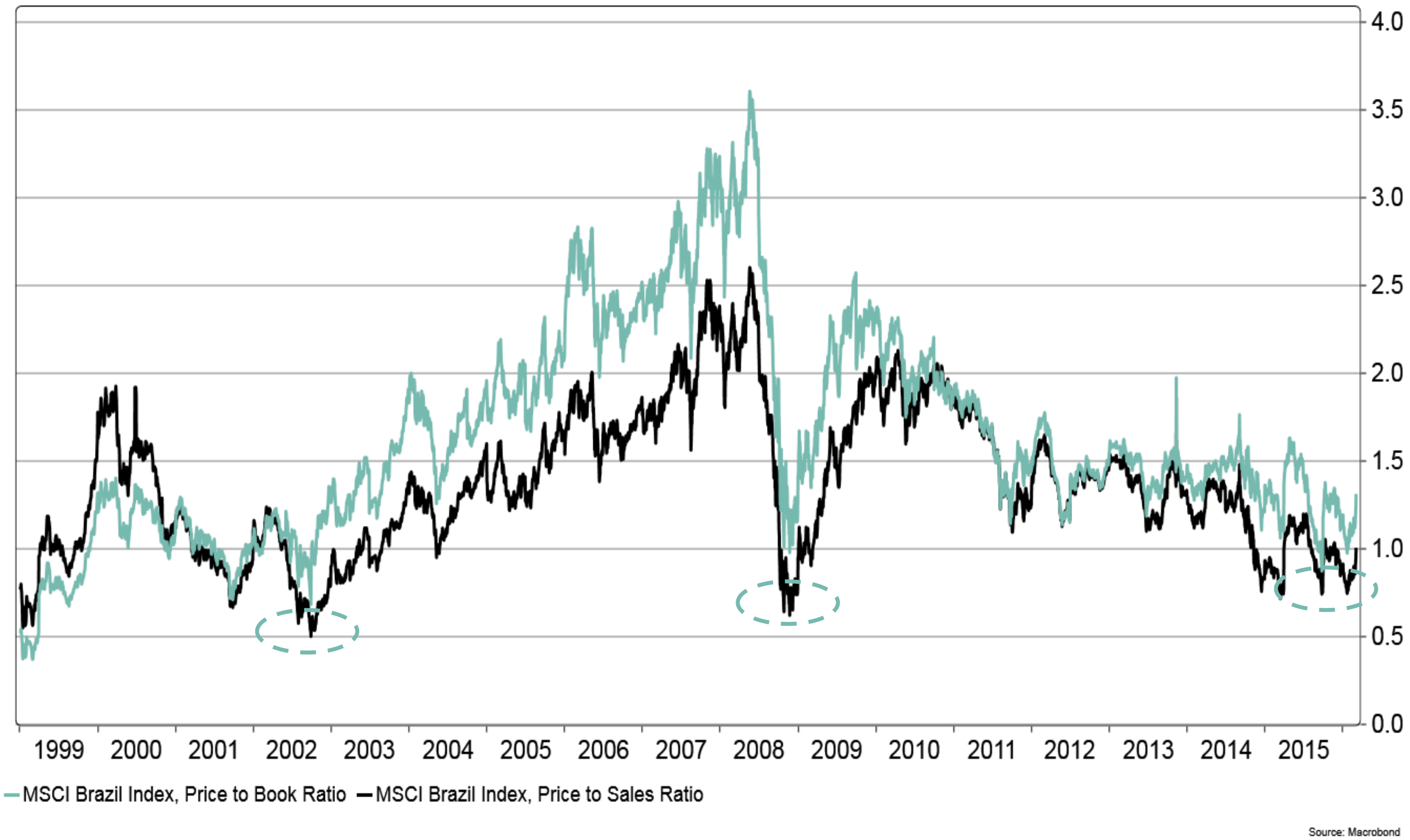
On various valuation metrics, such as price-to-book and price-to-sales, the index is back to the cheapest level since 2002 and 2008…

MSCI Brazil Index | Price-to-Book and Price-to-Sales Ratios



Source: Macrobond

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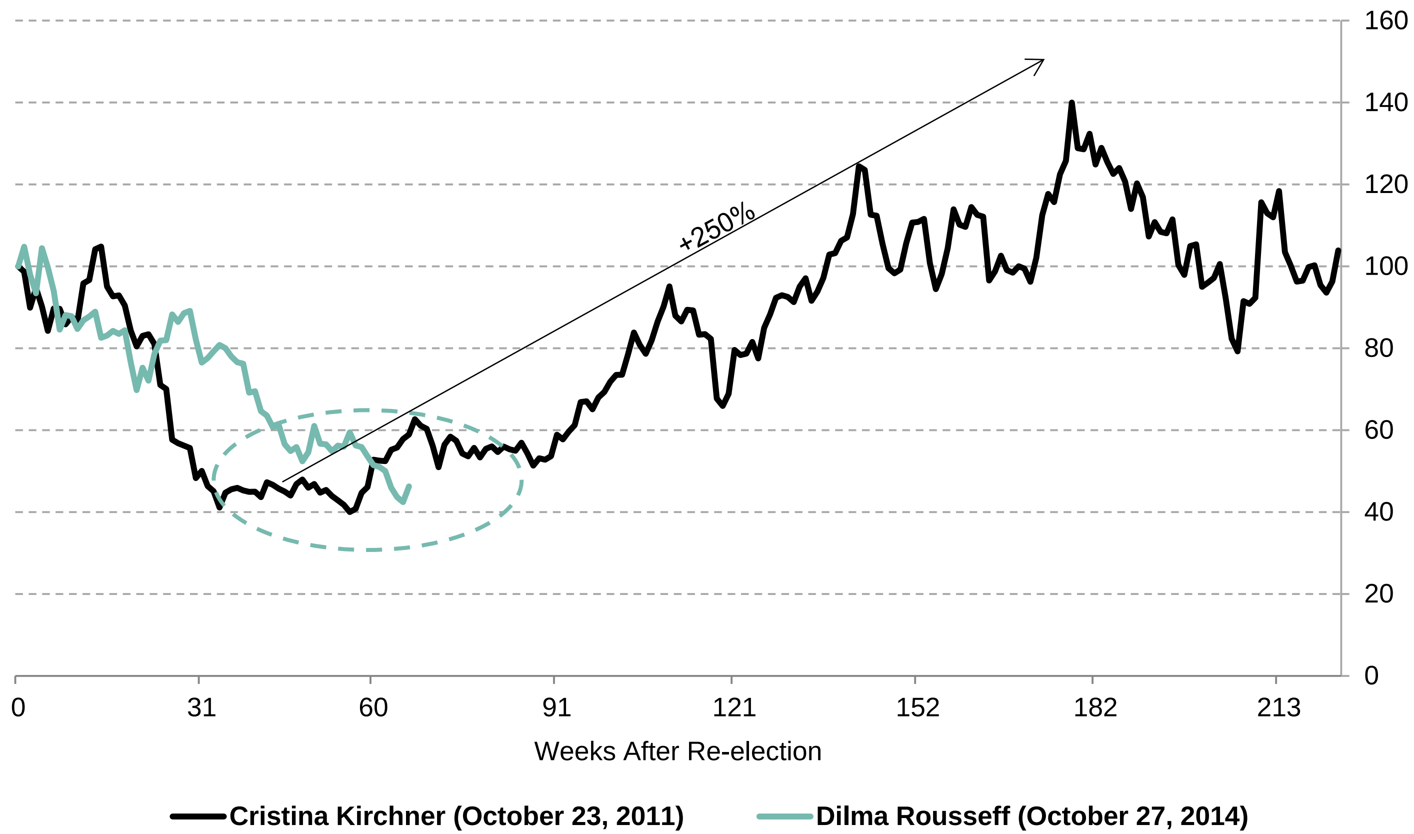
As evidenced by Argentina, political transitions can unleash a dramatic reversal in asset prices. With Brazil, it's unclear whether Dilma will leave in 2016 or 2018 (as part of the country's next election). However, as the economy deteriorates and the scandal encroaches on her, the probability of an early exit is increasing.

MSCI Argentina vs MSCI Brazil (USD) | Index 100, Weeks After Re-election



Source: Bloomberg

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