

BIENVILLE GLOBAL REVIEW

BRAZIL: WITH DILMA SIDELINED, WHAT NOW?

June 2016





WITH DILMA SIDELINED, WHAT NOW?

Summary

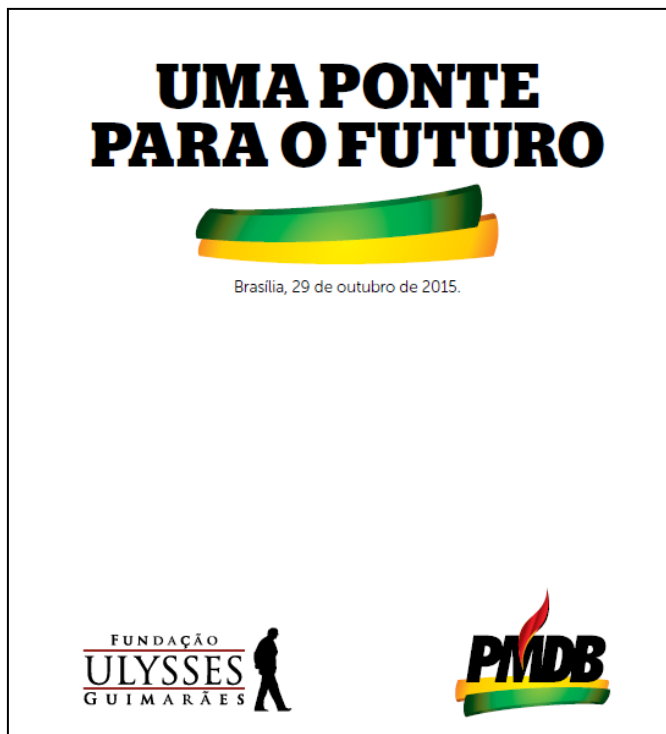
President Dilma has been sidelined, handing the presidency to Vice President Michel Temer for 180 days while the Senate conducts their impeachment deliberations. Temer has moved swiftly, naming his cabinet and announcing modest fiscal reform. Execution risks remain, and the “Car Wash” investigation continues. But thus far, Temer has demonstrated a willingness to deliver the confidence boost necessary to end the vicious feedback loop that has wreaked havoc on the Brazilian economy.

- As acting president, Temer currently has support from two of the three major political parties. An unlikely Presidential candidate in 2018, he is in a position to propose unpopular, yet necessary reforms for Brazil.
- Tighter fiscal policy, loose monetary policy and structural reforms are Temer’s prescription. If successful, it would put his pro-business party (PMDB) in a strong position to capture the Presidency in 2018.
- Despite many good cabinet selections, specifically on the economic team, risks from the “Car Wash” scandal remain (as exemplified by the resignation of two ministers shortly after their appointments). If the Temer government were to fall, then the political environment should continue moderating with the 2018 elections.
- In the medium term, privatizations and new infrastructure projects should help to reduce unemployment, increase capacity utilization levels, and ultimately expand the country’s output potential.
- When in crisis, political changes leading to marginal improvements in a country’s macroeconomic conditions can have large, positive impacts on asset prices. Argentina and India provide relevant analogs.
- The 5-year bear market in Brazil, where equities fell 75% in USD terms, has created an odd dynamic. Local asset managers have crowded into similar positions (i.e., large, liquid equities that also comprise the ETF). The result is a considerable disparity in valuations within the equity universe, creating a compelling opportunity for value-minded investors who are willing to serve as liquidity providers at a time of distress.

WITH DILMA SIDELINED, WHAT NOW?

While serving as Vice President, Temer's party (the PMDB) published their economic plan, outlining several key reforms to improve Brazil's fiscal situation and growth prospects...

"A Bridge to the Future" (October 29, 2015)



Highlights:

- Stabilize debt-to-GDP and return inflation to the 4.5% target level.
- Establish a limit for public spending at a level below the growth rate for GDP and eliminate the indexation that causes spending to rise in real terms.
- Propose a private sector investment plan focused on privatizations and concessions in logistics and infrastructure.
- Promote legislation to guarantee the best possible level of corporate governance for state-owned enterprises.



WITH DILMA SIDELINED, WHAT NOW?

Now as acting President, Temer has named a cabinet—one with considerable competence and credibility—to assist with execution. Meirelles' acceptance of the Finance Minister role was key...

New Cabinet Appointments

Name	Position	Comments
Henrique Meirelles	Finance Minister	Introduced inflation targeting to the central bank during Lula's presidency. Also has private sector experience and substantial political capital.
Ilan Goldfajn	Central Bank Governor	Worked at the central bank for several years. Most recently a prominent sell side economist at Itau, where he called for the central bank to cut rates by 425bps.
Eliseu Padilha	Chief of Staff	Leading PMDB figure. Former Transportation Minister and Head of Civil Aviation.
Alexandre de Moraes	Justice Minister	Renowned law professor. Also worked on the defense of former House Speaker Eduardo Cunha.

WITH DILMA SIDELINED, WHAT NOW?

Meirelles recently announced a series of budgetary measures and will soon propose structural reforms currently being negotiated among the PMDB and PSDB parties...

Henrique Meirelles - Finance Minister



Highlights of his recent fiscal announcements:

- No new taxes.
- Freeze on all public spending (a bill will be sent to Congress).
- BNDES to pay R\$100bn back to the Treasury in an expedited fashion.
- Accelerate approval in the Lower House of sector-level structural reforms: pension reform, pre-salt regulations, and state-owned company governance.



WITH DILMA SIDELINED, WHAT NOW?

Longer term, there is still ample room for structural reforms, provided they can gain sufficient support in Congress. If they do gather political backing, markets should respond favorably...

Areas For Structural Reforms

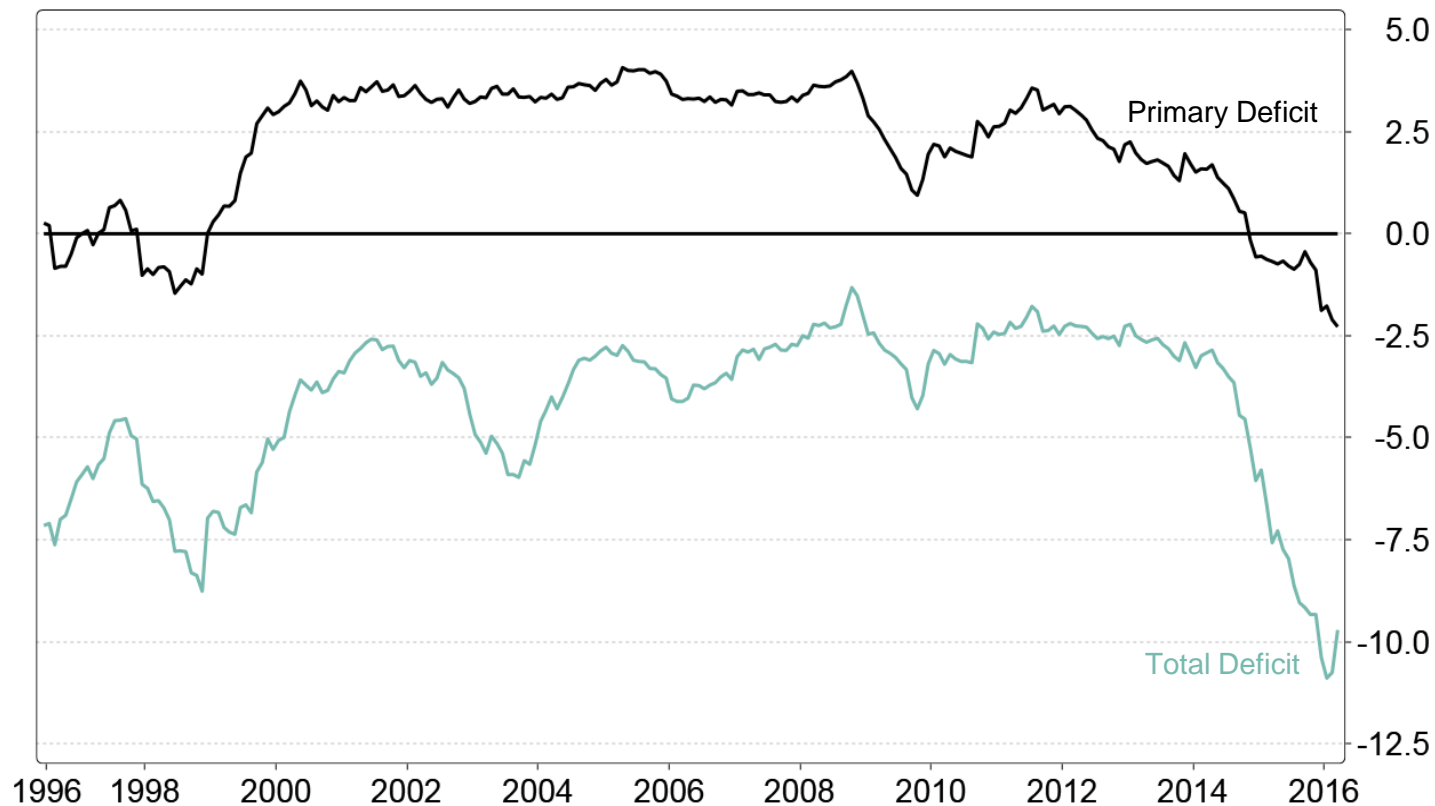
- Pensions – End the indexation of pensions to the minimum wage.
- Tax Burden – Brazil's tax burden is high in relation to peers, and compliance is very expensive. Other parties have drafted various proposals to simplify the tax code and lower overall taxes.
- Investment – Dilma depressed real returns 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 more 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 reduce spending from the current unsustainable pace to balanced over the long run.



WITH DILMA SIDELINED, WHAT NOW?

Addressing the budget is crucial. Fiscal profligacy under Dilma turned a primary surplus into a deficit, which contributed to rising interest rates that have exacerbated the overall budget deficit...

Primary & Total Deficits (% of GDP)



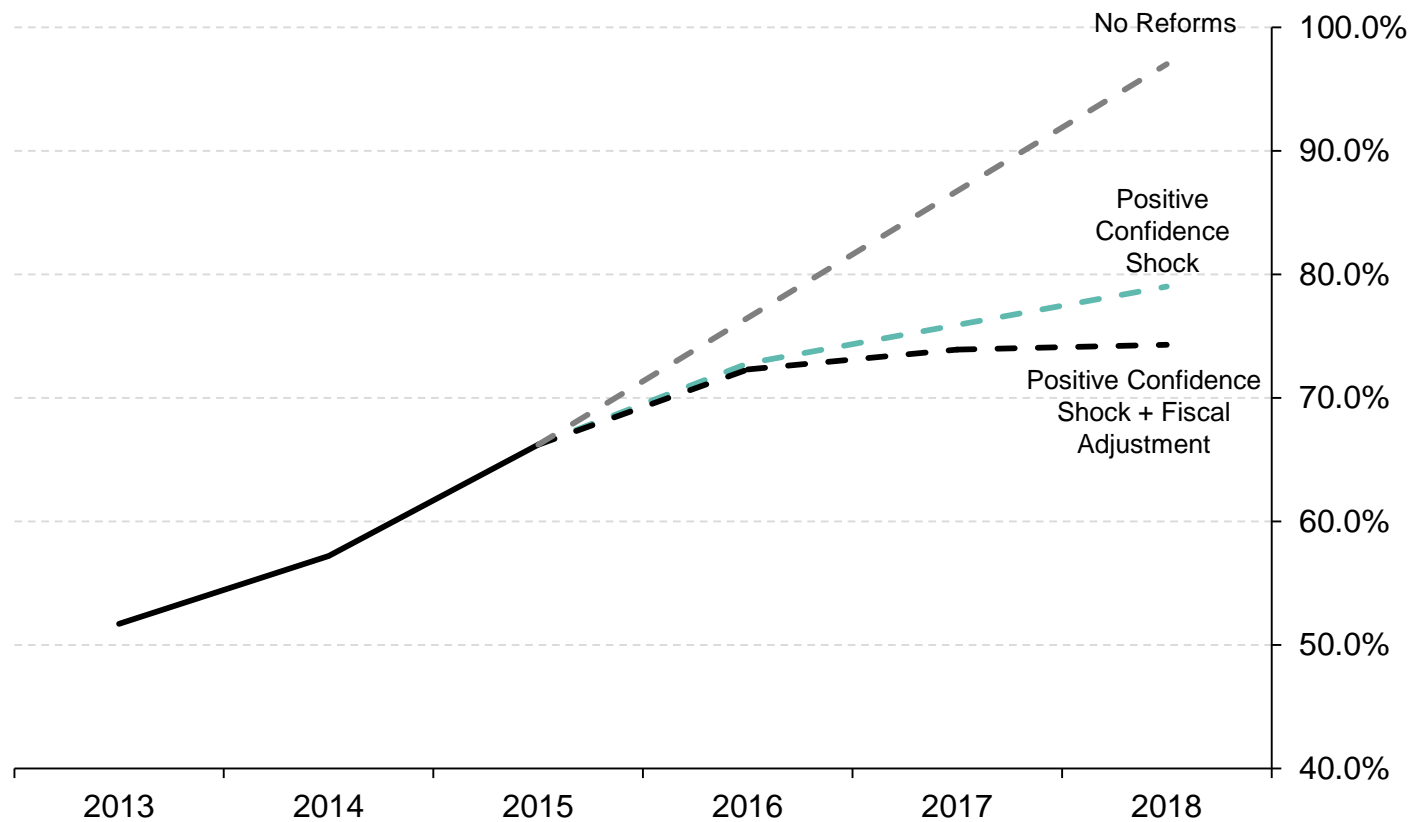
Source: Macrobond



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A credible plan to curtail the deficit should increase confidence, helping to spur growth and reduce interest rates, both of which are necessary to stabilize Brazil's debt-to-GDP...

Projected Gross Debt-to-GDP %

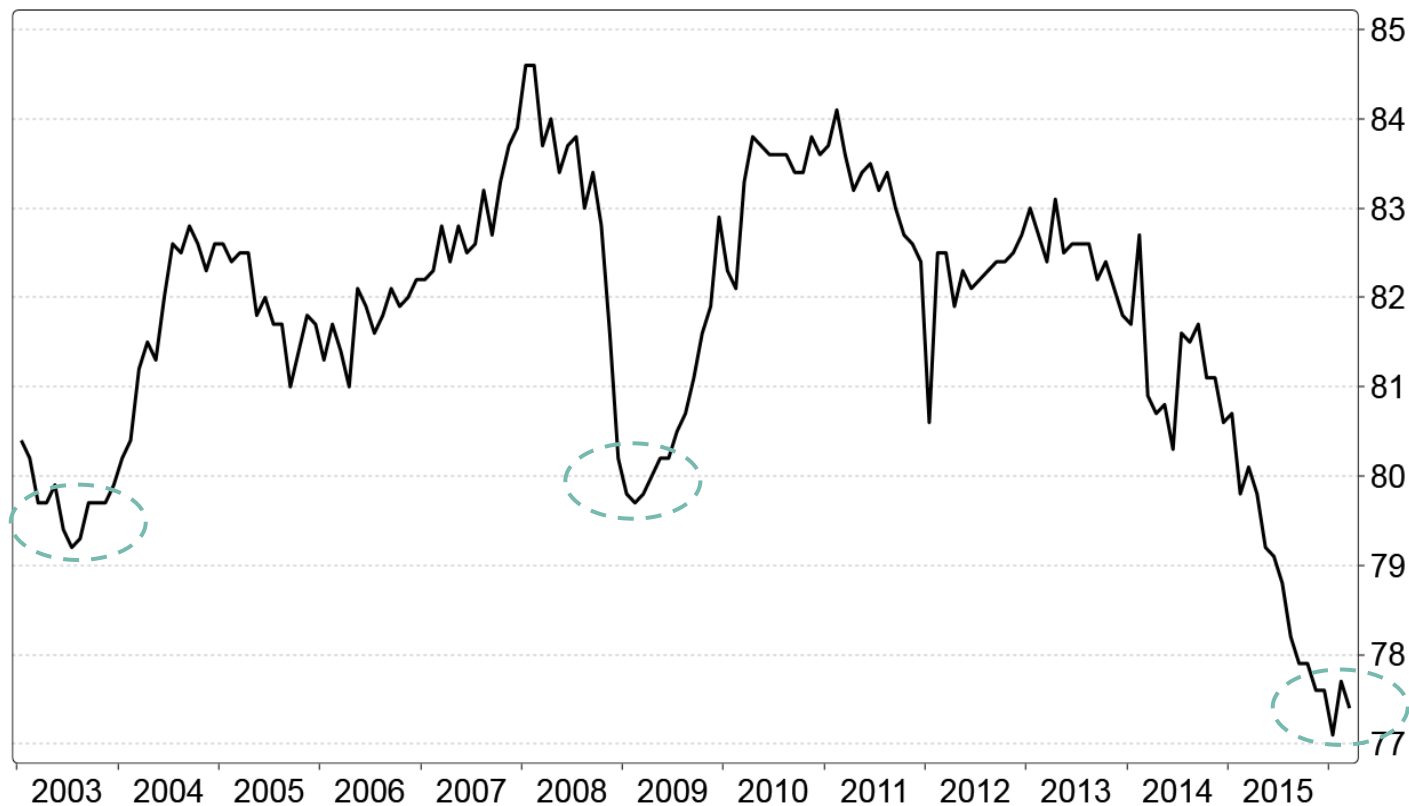




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Capacity utilization rates below the 2003 and 2008 levels illustrate the economic depression and overall slack in the economy. A positive confidence shock could help reinvigorate growth...

Capacity Utilization (%)



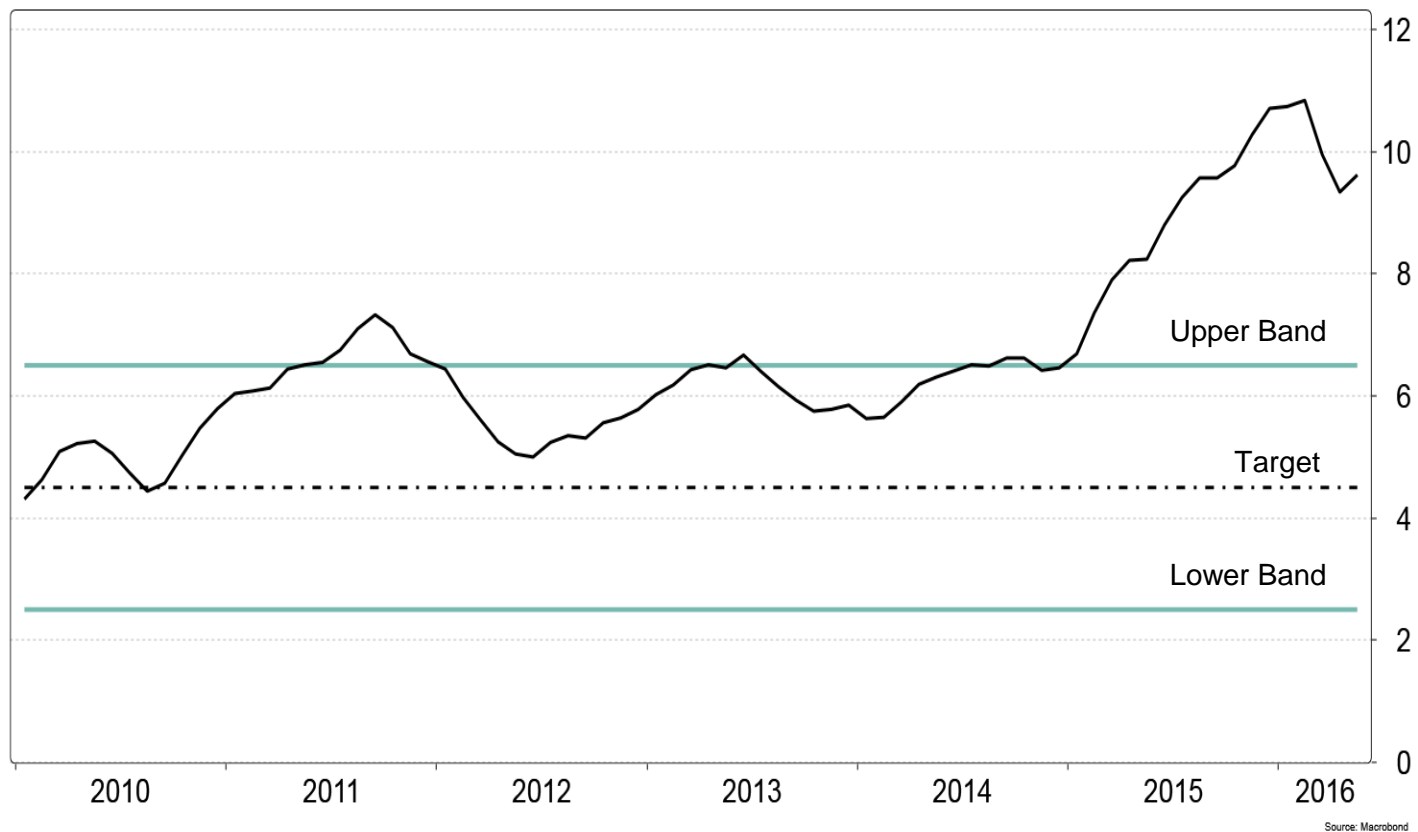
Source: Macrobond



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The economic slack is also reducing inflationary pressures. While high today, inflation rates should fall towards the target range providing an opportunity for the central bank to ease aggressively...

Inflation Rate (IPCA) vs. Central Bank Inflation Bands

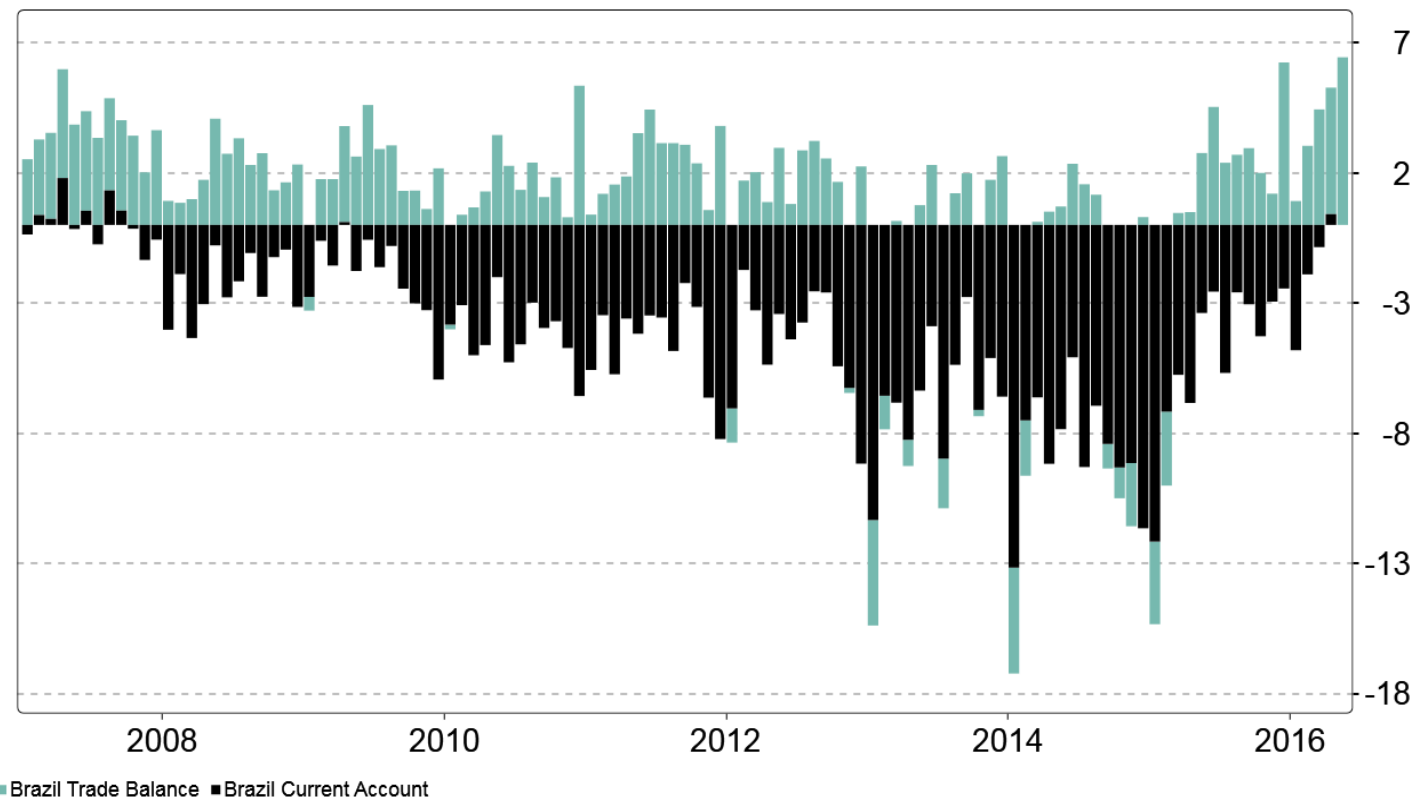




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As the currency depreciated from overvalued levels, the trade balance improved, leading to a needed adjustment of the current account. Normalized external balances should support growth and the BRL...

Brazil Current Account (Black) & Trade Balance (Green) in USD billions



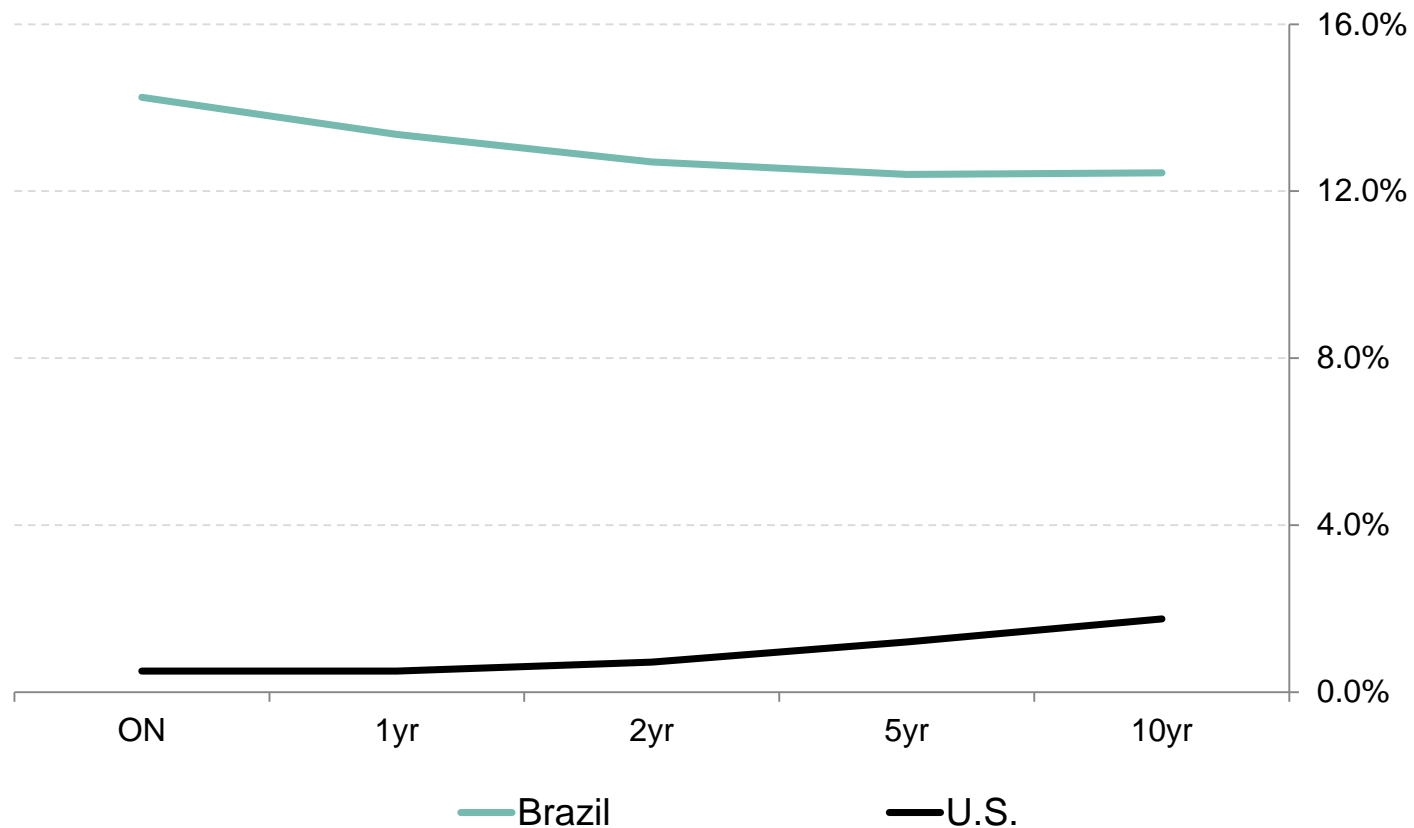
Source: Macrobond



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Nominal yields of 15% and inflation break-evens of 6.5% reflect elevated risk premium. If conditions stabilize and the central bank begins cutting rates, yields should compress...

Brazil vs. U.S. Yield Curve

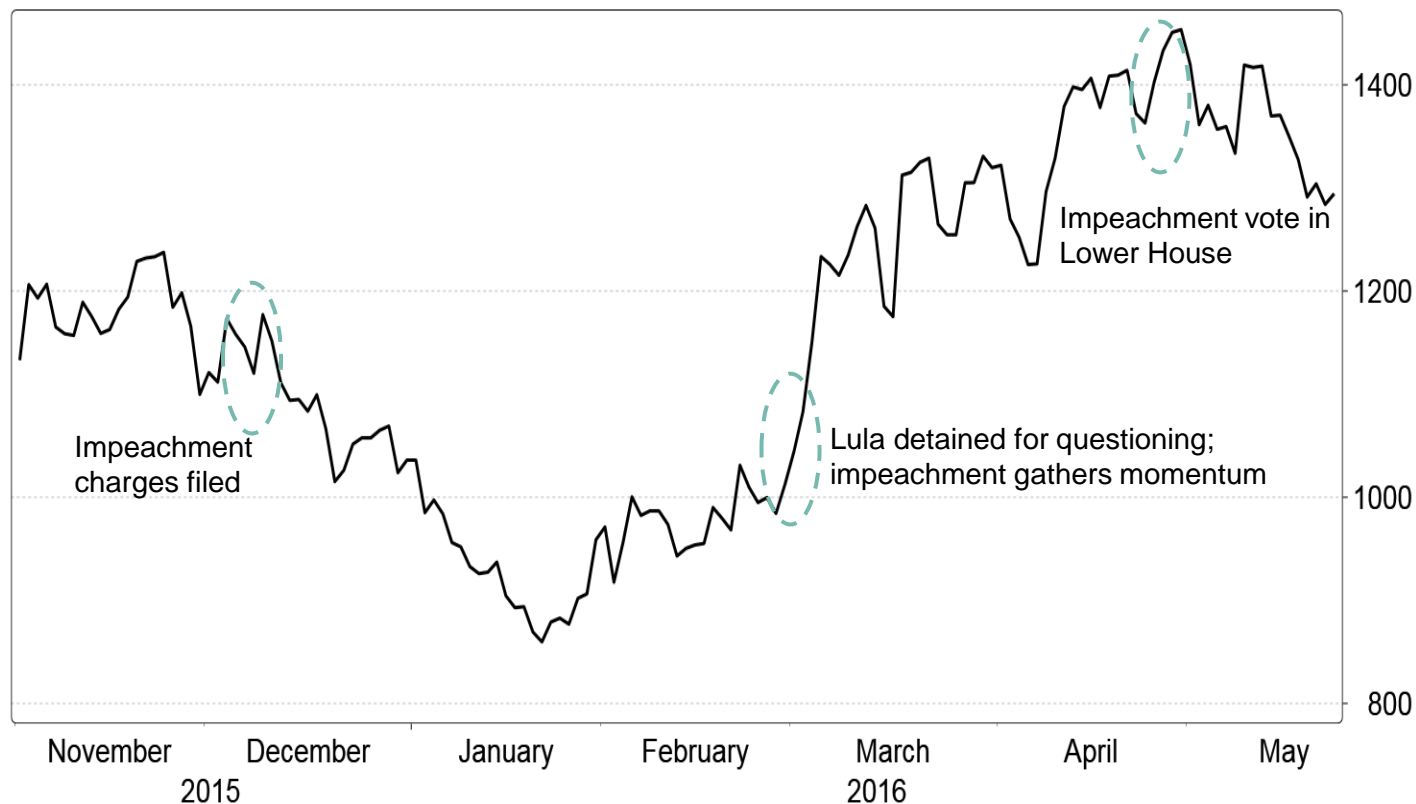




WITH DILMA SIDELINED, WHAT NOW?

As markets discounted Dilma's impeachment, Brazilian equities rallied. But recently, prices have retreated. Concerns over Temer's ability to execute reforms and the "Car Wash" investigation remain...

MSCI Brazil Index (USD)



Source: Macrobond

WITH DILMA SIDELINED, WHAT NOW?

New cabinet ministers have not been immune to corruption allegations, highlighted by the resignations of two of Temer's first appointments. However, legal pressures from Judge Moro could soon subside...

Sergio Moro – Federal Judge
(Leading the “Car Wash” Investigations)



Reasons investigative pressure may begin to ease:

- Existence of jurisdiction limits and legal restrictions going after sitting politicians accused of graft.
- Pushback from Supreme Court Justices like Marco Aurelio Mello, who said Moro's “show of force [in the leaked phone conversation between Lula and Dilma] overstepped his limits.”
- Judge Moro has stated he would keep pushing ahead as long as the public, who is now pleased that Dilma is gone, would support it.

WITH DILMA SIDELINED, WHAT NOW?

In fact, Judge Moro published a critique of Italy's 1990's anti-corruption campaign in 2004. His publication concluded that prosecutors went too far and left a political vacuum filled by new corruption...

“Considerations on Operation Clean Hands” (July 2004)

DIREITO PENAL

CONSIDERAÇÕES SOBRE A OPERAÇÃO MANI PULITE

Sergio Fernando Moro

RESUMO

Traça breves considerações sobre a operação *mani pulite*, na Itália, uma das mais impressionantes cruzadas judiciárias contra a corrupção política e administrativa.

Discute as causas que precipitaram a queda do sistema de corrupção italiano e possibilitaram a referida operação — entre elas os crescentes custos, aliados a uma conjuntura econômica difícil —, bem como a estratégia adotada para o seu desenvolvimento.

Destaca a relevância da democracia para a eficácia da ação judicial no combate à corrupção e suas causas estruturais e observa que se encontram presentes várias condições institucionais necessárias para a realização de ação semelhante no Brasil, onde a eficácia do sistema judicial contra os crimes de “colarinho branco”, principalmente o de corrupção, é no mínimo duvidosa. Tal fato não escapa à percepção popular, constituindo um dos motivadores das propostas de reforma do Judiciário.

PALAVRAS-CHAVE

Operação mãos limpas; *mani pulite*; Itália; corrupção; prisão pré-julgamento; prisão pós-julgamento; Lei n. 10.628/2002; Lei n. 7.492/86; ação judicial; propina.

Moro's Findings from “Clean Hands”:

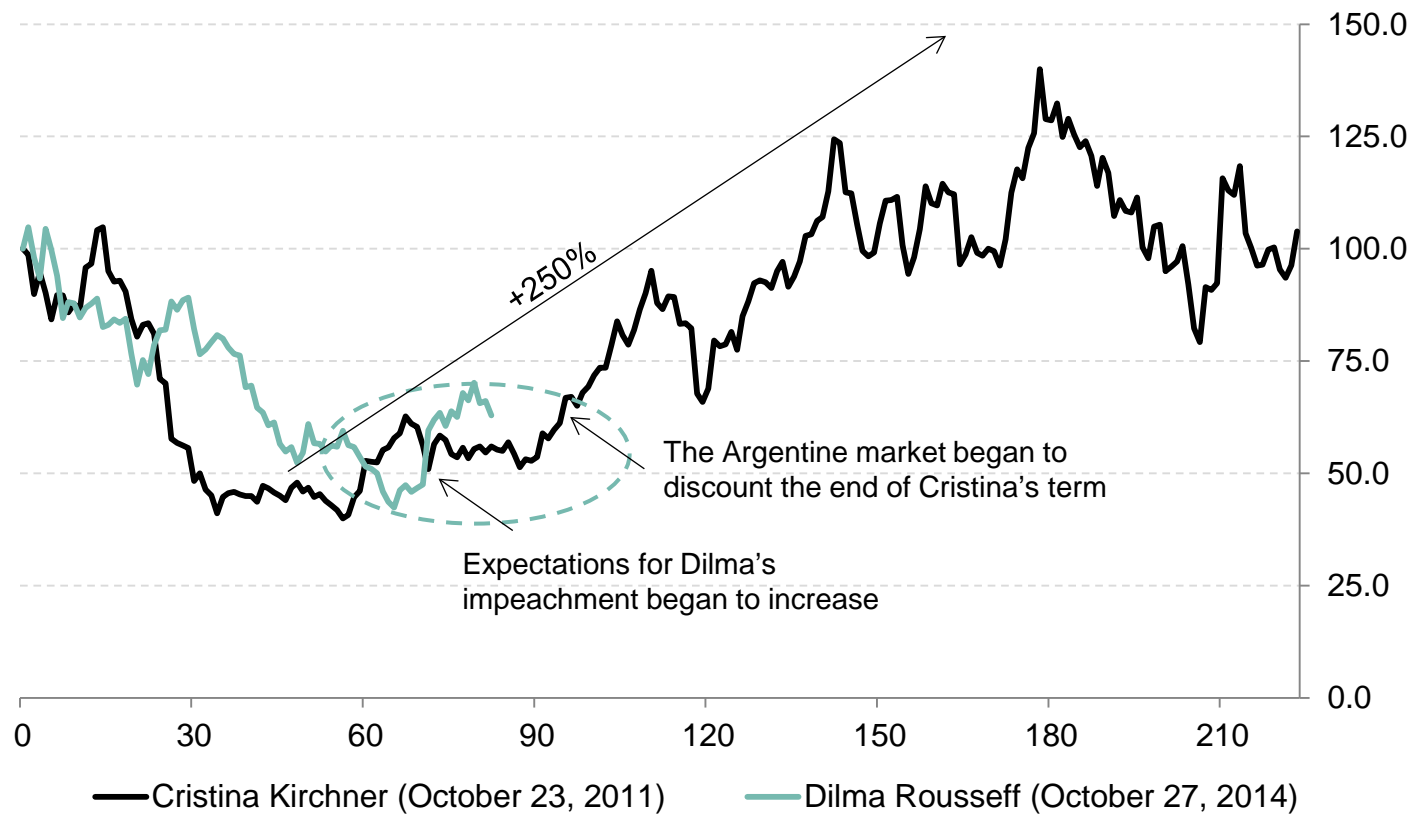
- Popular support and press cooperation are paramount to overall success of any anti-corruption campaign.
- Plea bargains are an effective tool for extracting information to indict higher-level officials.
- **Italian officials went too far.** Taking down the two main parties left a political vacuum filled by Silvio Berlusconi, who started an entirely new cycle of corruption.



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Prior examples of markets discounting political change and economic stabilization can be seen most recently in Argentina...

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

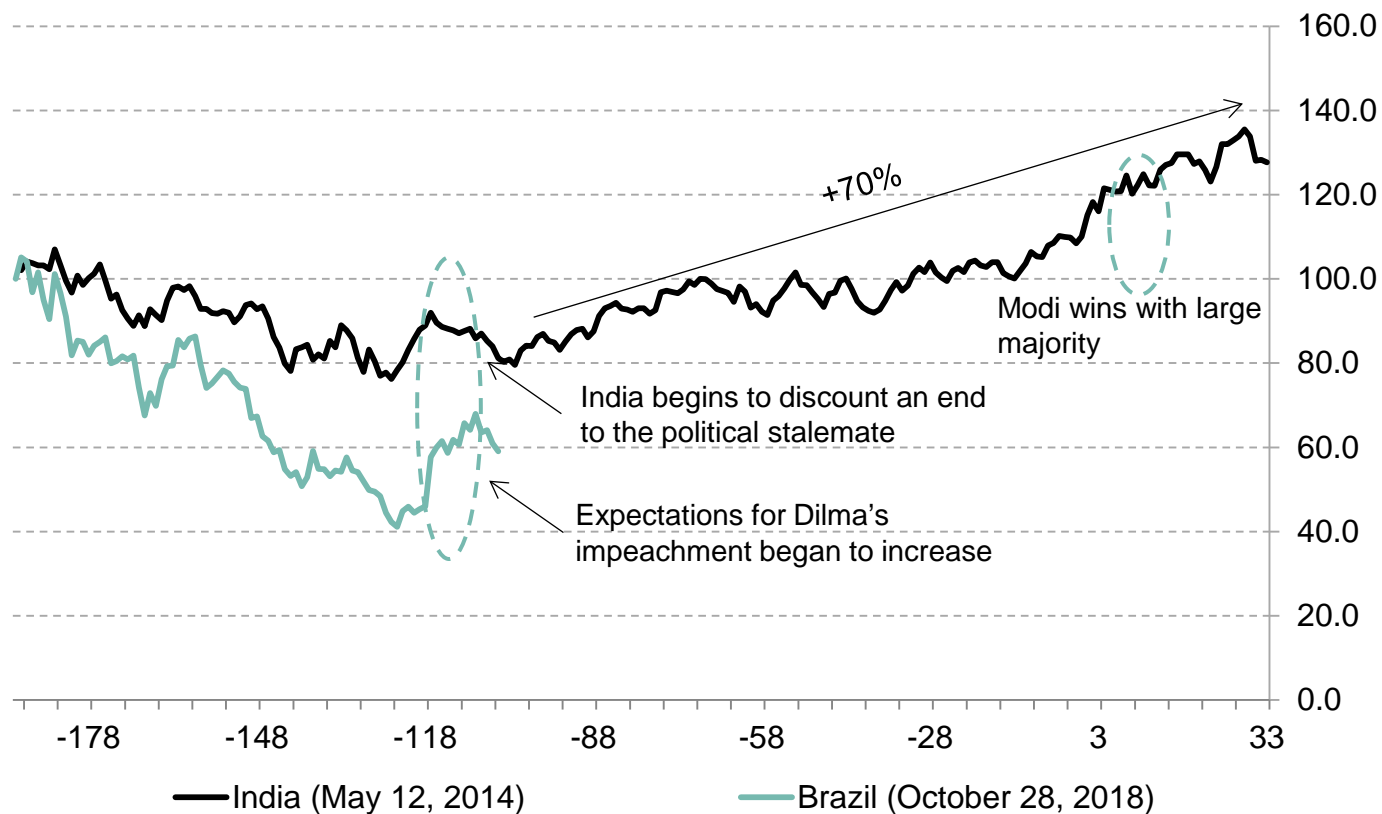




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As well as in India, where a corruption scandal was followed by an investment freeze and political stalemate. The market began discounting stabilization two years before the general election...

MSCI India (USD) vs MSCI Brazil (USD) | Index 100, Weeks Before General Election





WITH DILMA SIDELINED, WHAT NOW?

Creating 'alpha' will require selecting the right companies—those most convex to an improvement of conditions in Brazil. Due to liquidity, many local funds have been herding into the very same companies as the index, leaving a large universe of compelling businesses with little sponsorship...

Equity Holdings of Largest Brazil Fund Managers

Company	No. of Brazil Funds That Own
Itausa	49
Cielo	40
Itau Unibanco	32
Banco Bradesco	32
Equatorial Energia	27
BB Seguridades	27
Brasil Foods	25
Suzano	25
CETIP	23
Telefonica Brasil	21



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