

BIENVILLE GLOBAL REVIEW

BRAZIL: WITH DILMA GONE, HAS THE CYCLE TURNED?

September 2016





WITH DILMA GONE, HAS THE CYCLE TURNED?

Summary

With the recent ratification of Dilma's impeachment, Michel Temer takes over as President until the 2018 elections. Under Dilma, political crisis prevented governability. As a result, the Brazilian economy suffered a depression. Her departure represented a much-needed positive confidence shock, igniting a rally in Brazilian assets that is now stimulating the real economy. As the credit crunch dissipates, a new economic cycle could be underway. And with inflation falling, the central bank has ample room to cut interest rates, alleviating the country's debt burden. Despite a rally off of January's capitulation levels, we believe Brazilian assets remain cheap.

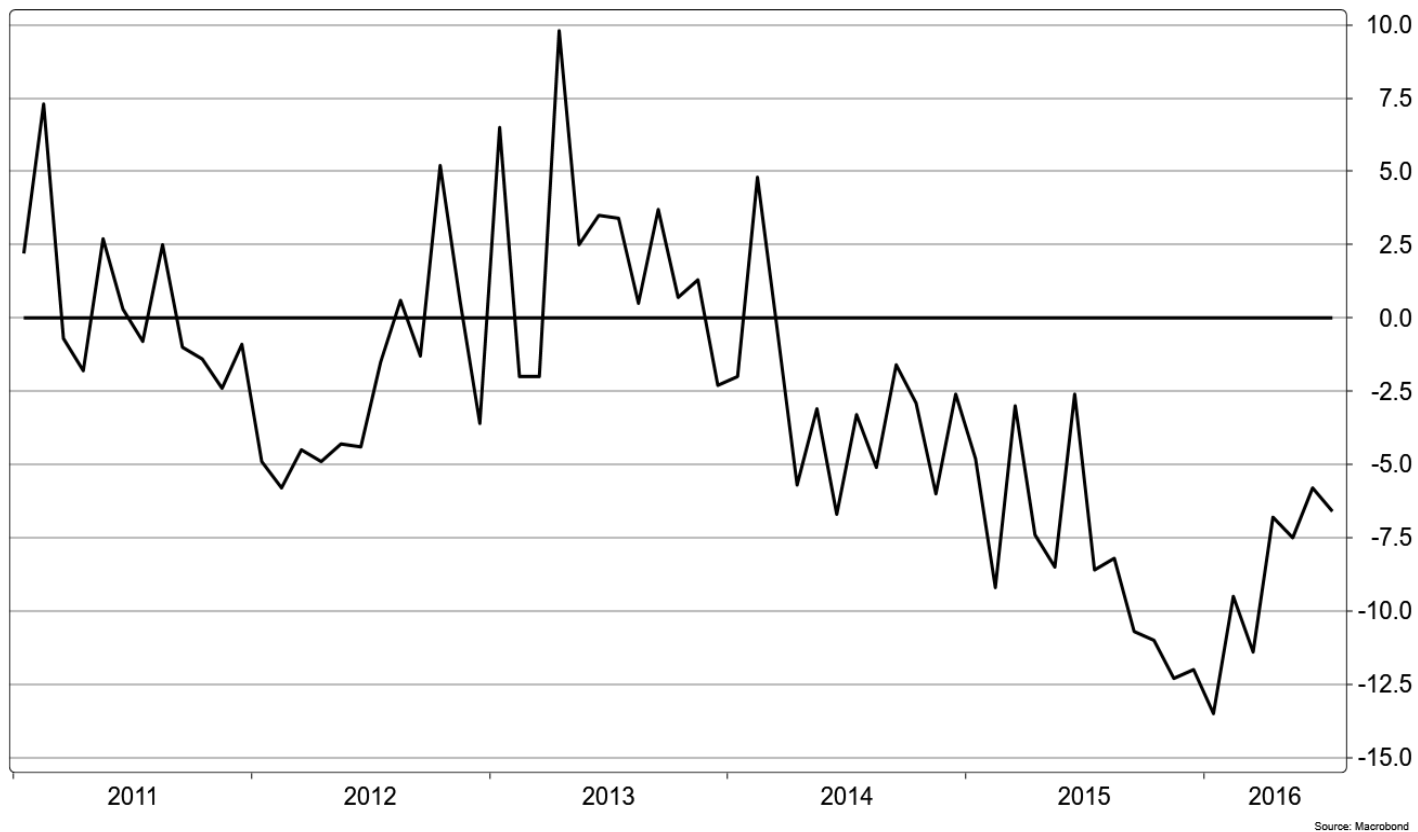
- With Dilma gone and a rally in emerging markets, Brazil's country risk has plummeted, driving equity and bond prices higher while simultaneously lowering the cost of capital for corporates.
- Inflation appears to have peaked, thanks in part to a strengthening currency. Excess capacity is also present. The central bank may begin cutting policy rates in Q4, the start of what could be an aggressive easing cycle.
- After three years of recession, economic green shoots are now appearing. There seems to be light at the end of the tunnel.
- Stimulative effects aside, lower interest rates should also improve Brazil's debt dynamics, a critical component of the reform agenda and a remaining concern for global investors.
- With the impeachment officially complete, Temer can now pursue fiscal reform. It will be a difficult task and setbacks are to be expected.
- Brazilian bonds and equities have rallied from extreme levels, and after a five year bear market, the equity market is now one of the world's top performers. In terms of rate of change, Brazil has gone from "really bad" to "less bad." But if the cycle has indeed turned, we could be in the early innings of a recovery.



WITH DILMA GONE, HAS THE CYCLE TURNED?

Industrial production has begun to recover from the crisis levels witnessed earlier this year.

Industrial Production (YoY % Change)





WITH DILMA GONE, HAS THE CYCLE TURNED?

Business confidence has bounced significantly, approaching more normalized levels.

Business Confidence Index

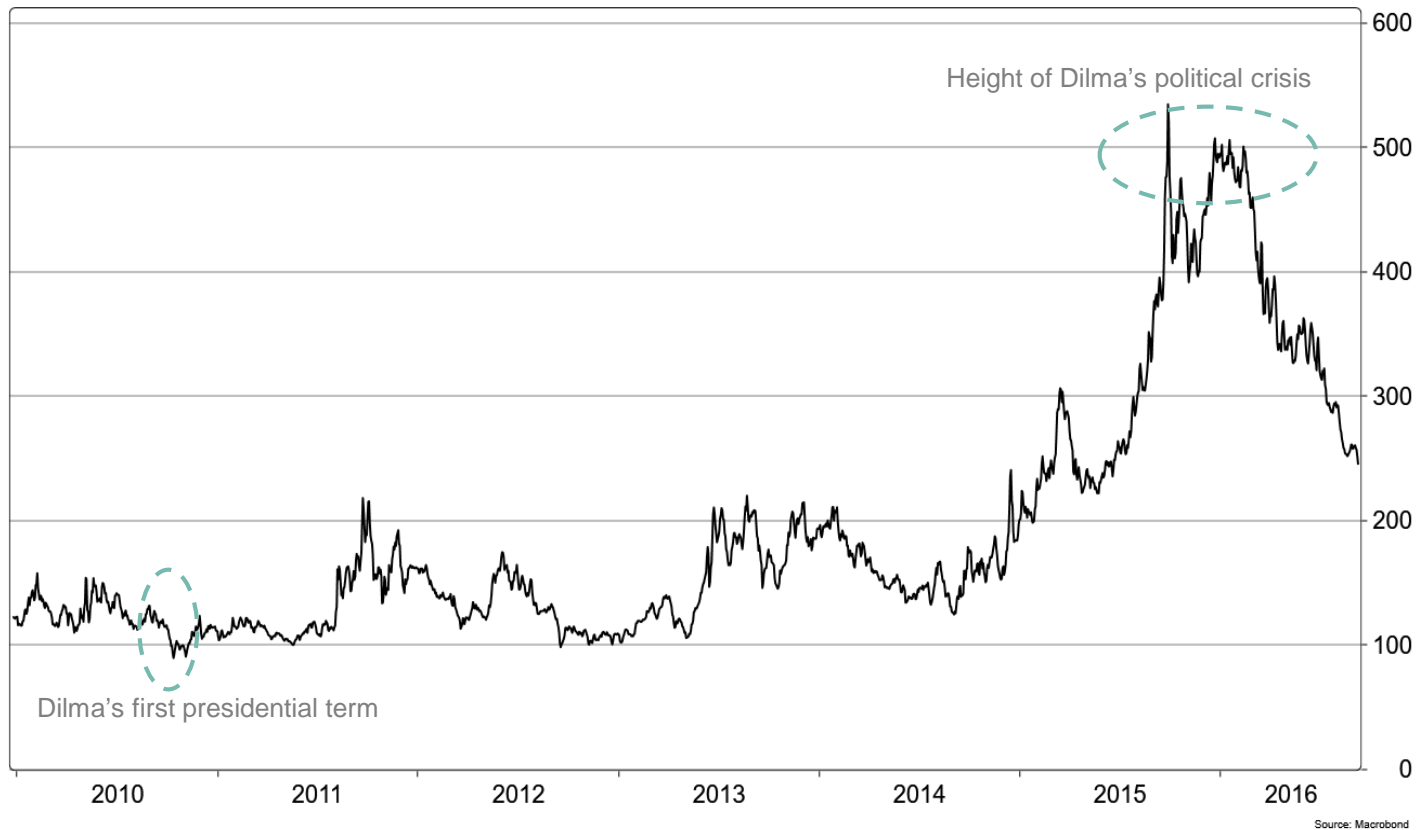




WITH DILMA GONE, HAS THE CYCLE TURNED?

Brazil's credit spreads exploded during the peak of the 2015 political crisis, but then compressed alongside the departure of Dilma. With an economic stabilization, spreads could fall further.

Brazil CDS Spread (Bps)





WITH DILMA GONE, HAS THE CYCLE TURNED?

The Brazilian *real* is arguably a barometer for investor confidence. After a significant devaluation, the BRL has appreciated by nearly 20% this year, improving the country's inflation dynamics.

USDBRL Spot Rate

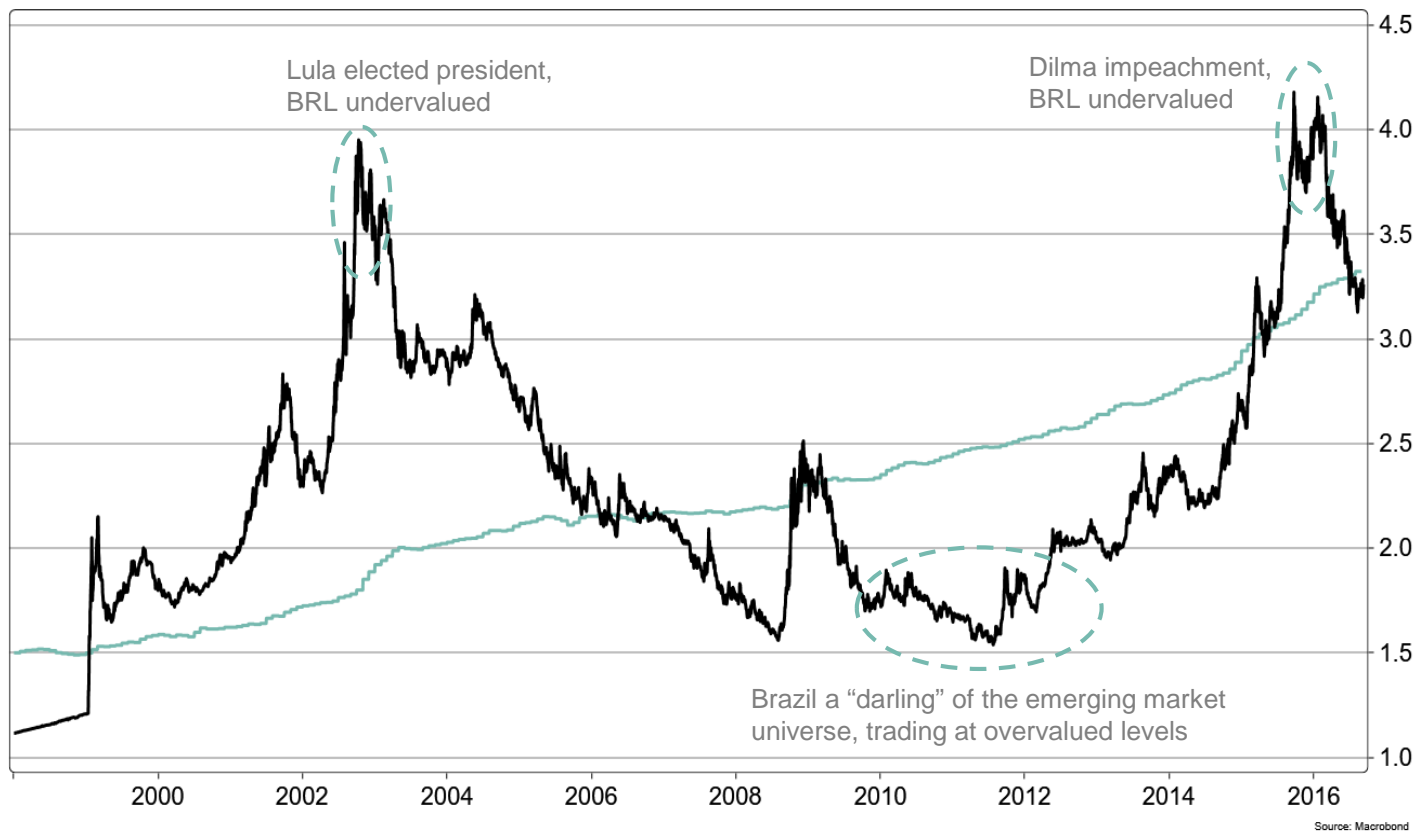




WITH DILMA GONE, HAS THE CYCLE TURNED?

After a clear overshoot earlier this year, the *real* has returned to fair value. In past up-cycles, the currency has tended to trade expensive relative to fair value.

BRL vs Fair Value

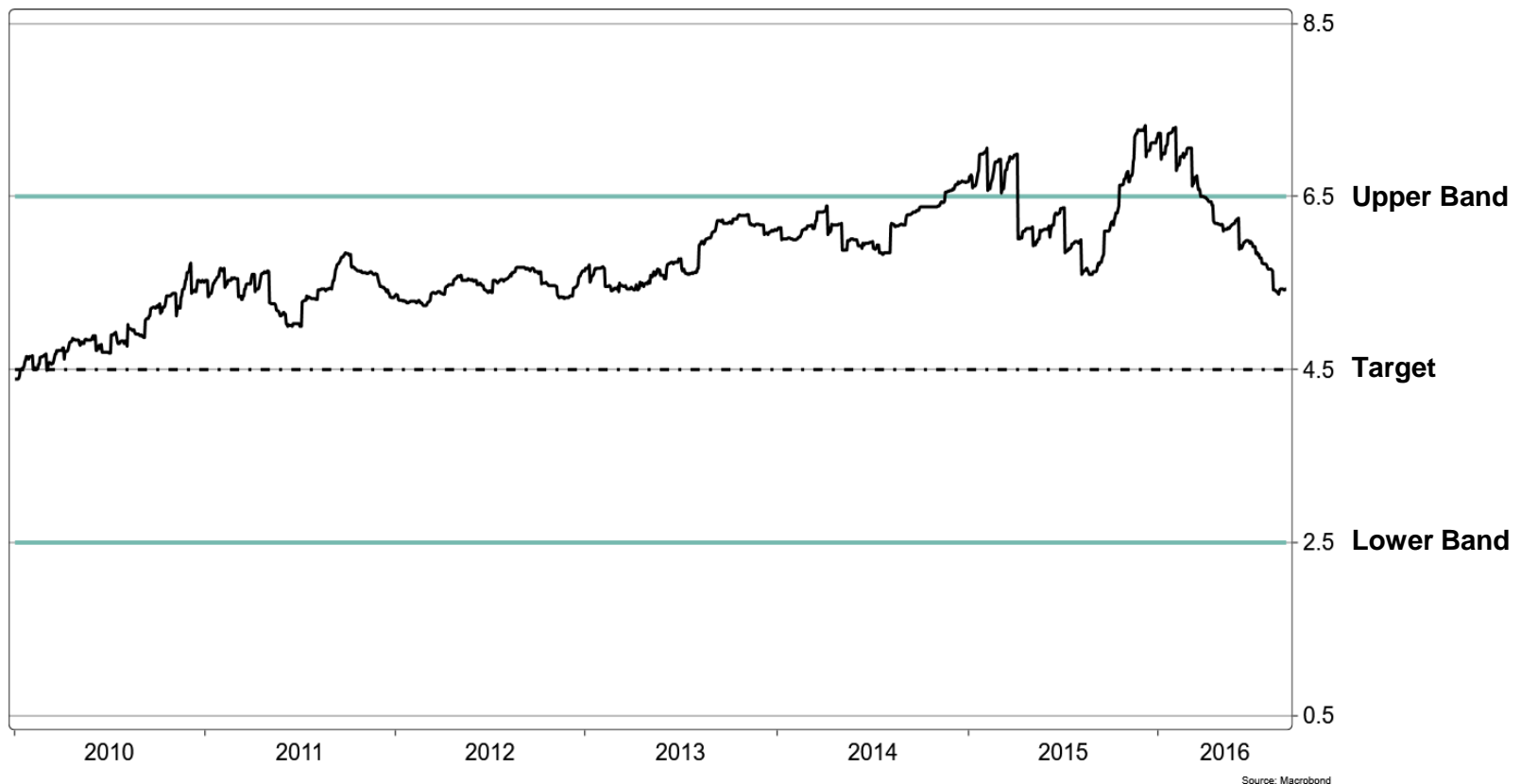




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Excess capacity is also contributing to a decline in both inflation expectations and actual inflation. Further disinflation should allow the central bank to begin cutting rates in the fourth quarter of 2016.

Inflation Expectations vs Central Bank Target Range (%)

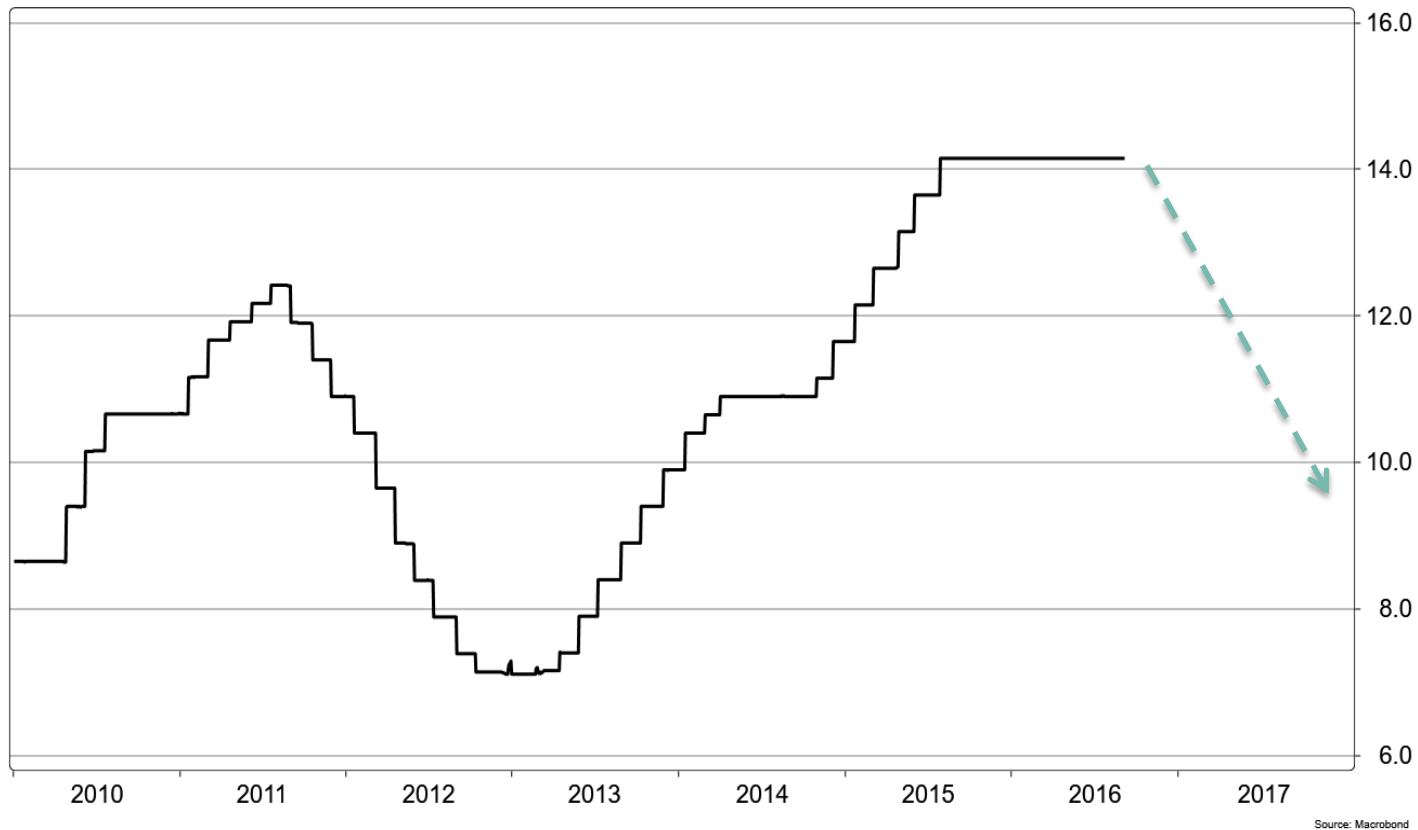




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And with current policy rates at 14.25%, there is ample room to cut.

SELIC Overnight Rate (%)





WITH DILMA GONE, HAS THE CYCLE TURNED?

The long end of the yield curve has begun anticipating a decline in policy rates, collapsing nearly 500bps so far this year.

Brazilian Local 10-Year Bond Yield (%)



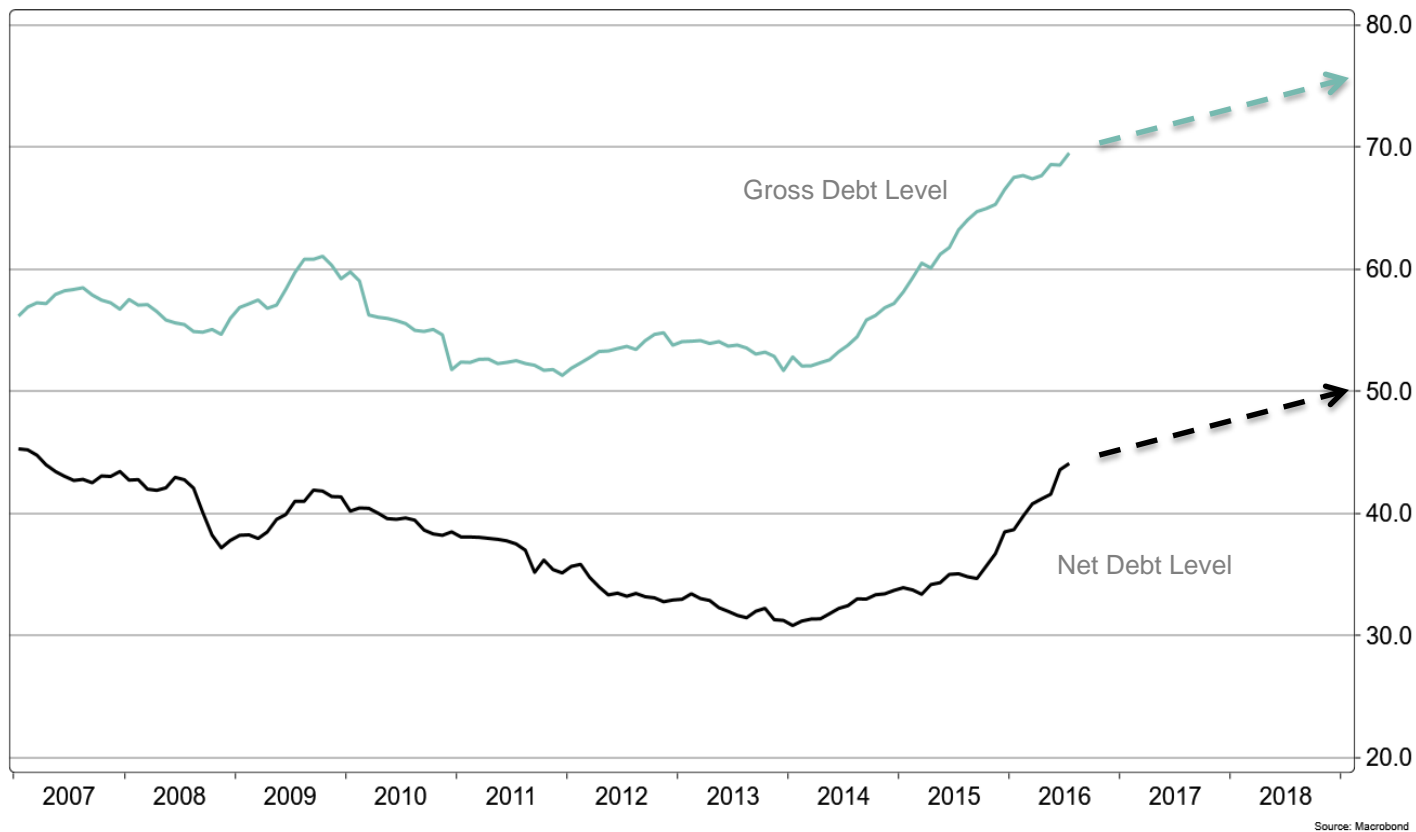
Source: Macrobond



WITH DILMA GONE, HAS THE CYCLE TURNED?

A challenge of the Temer administration will be to tackle the fiscal deficit in order to stabilize the country's debt burden.

Brazilian Gross and Net Government Debt (% of GDP)

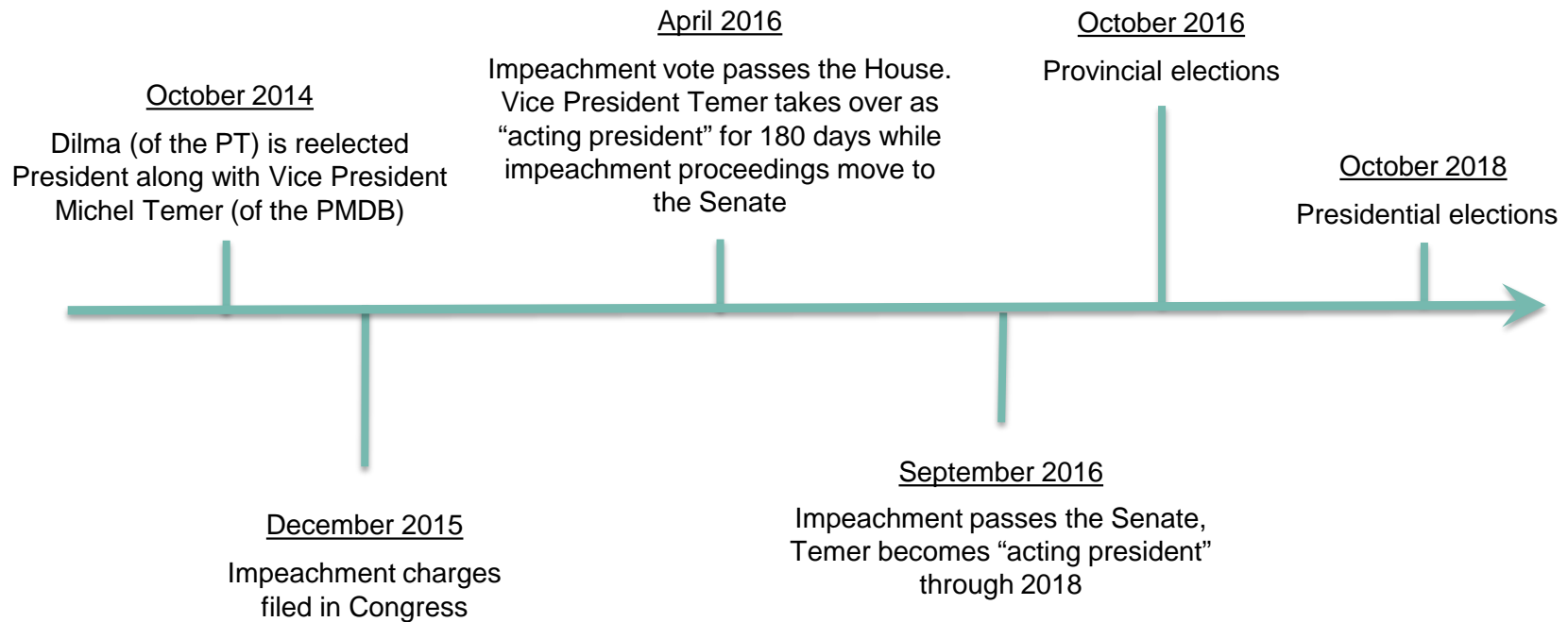




WITH DILMA GONE, HAS THE CYCLE TURNED?

Now that Dilma's impeachment is complete, Temer can begin the difficult task of implementing reforms, which are likely to be modest at the onset. Political setbacks are to be expected.

Political Timeline





WITH DILMA GONE, HAS THE CYCLE TURNED?

Even though conditions have begun to improve, Brazil still has a higher sovereign spread than Turkey, which recently experienced an attempted coup, and higher local interest rates than Nigeria.

Brazilian Rates and Sovereign Spreads vs. EM Peers

Country	Local Policy Rate	Sovereign Spread	Comment
Brazil	14.25%	309bps	Entering stability post-impeachment
Turkey	7.50%	306bps	Recent coup attempt
South Africa	7.00%	268bps	President in political crisis
Mexico	4.25%	254bps	Unpopular president and problems at PEMEX
Colombia	7.75%	222bps	Recently settled with FARC guerillas
Nigeria	14.00%	470bps	Massive currency devaluation this year



WITH DILMA GONE, HAS THE CYCLE TURNED?

In December and January, equity investors panicked. Since this period of capitulation, equities have appreciated significantly in USD terms, thanks in part to the performance of the BRL.

MSCI Brazil (USD)



Source: Macrobond



WITH DILMA GONE, HAS THE CYCLE TURNED?

Performance in local currency has been less than in dollar terms, but the 35% gain has made Brazil a top-performing equity market in 2016.

Ibovespa (BRL)



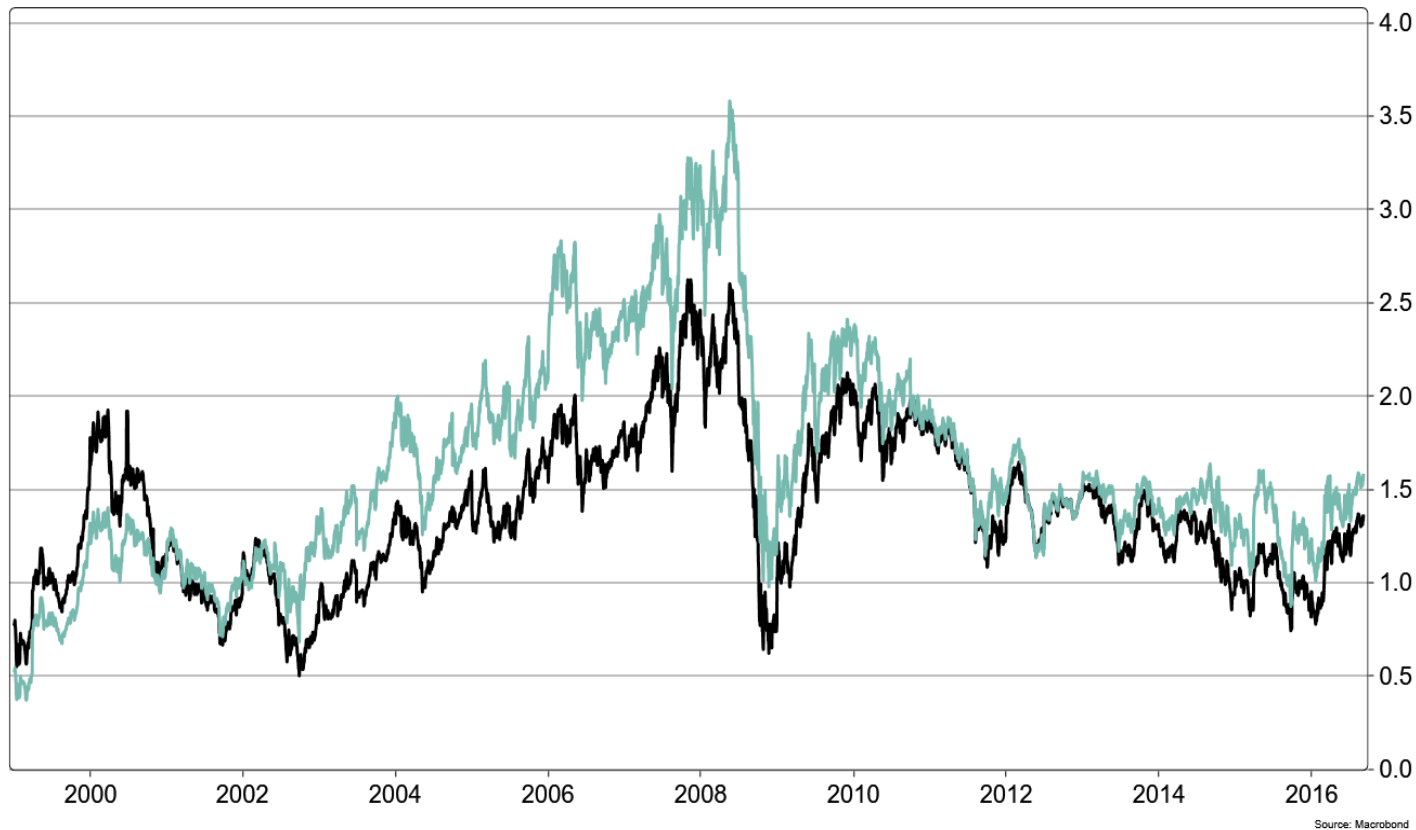
Source: Macrobond



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Despite the rally, we believe valuations are still reasonable—far from prior market peaks—and the economy is still underperforming, depressing corporate fundamentals.

Price to Book (Green) and Price to Sales (Black)





WITH DILMA GONE, HAS THE CYCLE TURNED?

The equity market remains well below the levels of 2008 and 2010. If the economy stabilizes and reforms are passed, equities could continue to recapture some of the losses from previous peaks.

Ibovespa (USD)





WITH DILMA GONE, HAS THE CYCLE TURNED?

Brazil has experienced pronounced cycles as equities have exhibited multiple “V-bottoms” within a strong uptrend. A return to the midpoint of this channel would represent significant additional upside.

Ibovespa (USD) Since 1963

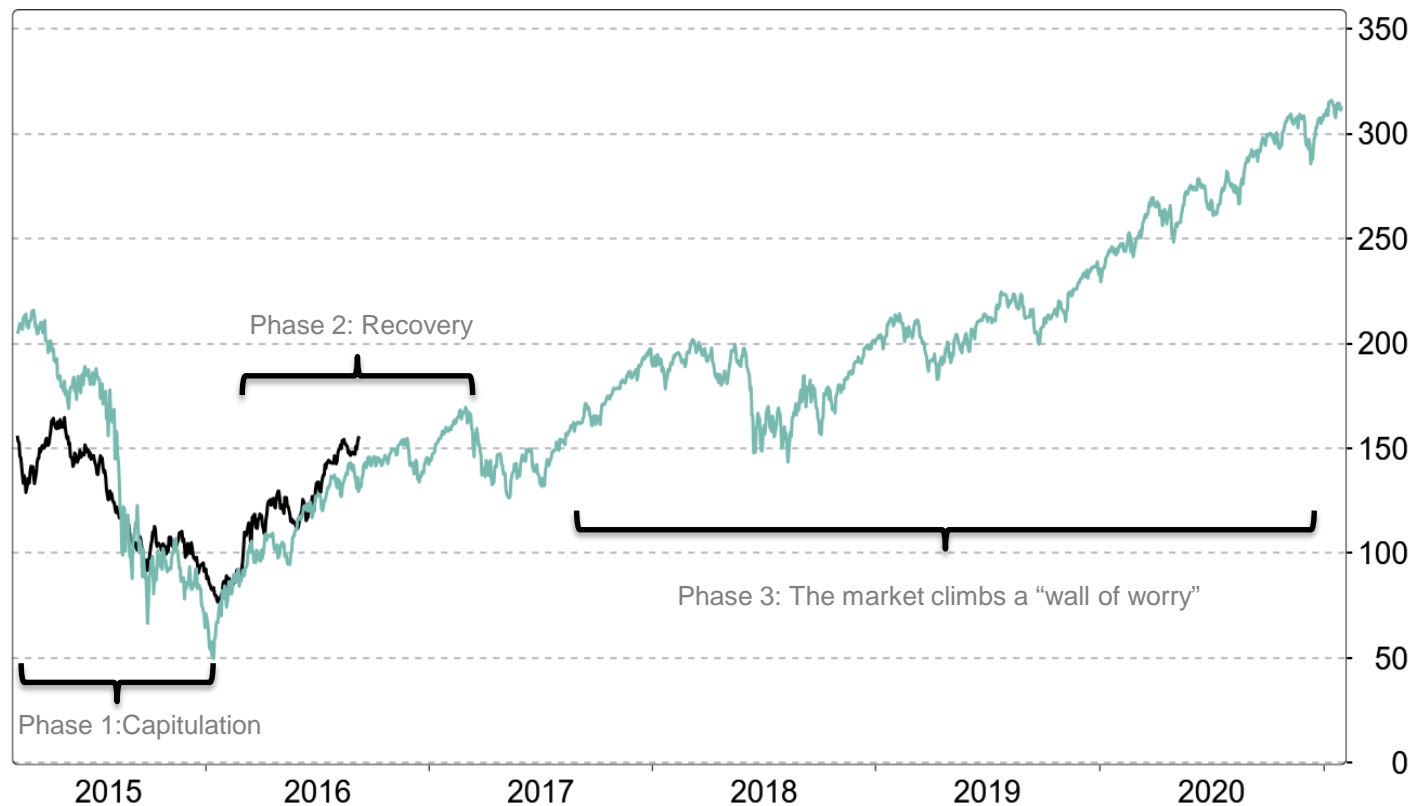




WITH DILMA GONE, HAS THE CYCLE TURNED?

An intriguing parallel to consider is the current price action of Brazilian equities relative to the S&P 500 during the financial crisis. After a period of capitulation and recovery, the market climbed a “wall of worry” as investor concerns over seemingly intractable problems dissipated.

MSCI Brazil (2015) vs. S&P 500 (2008-2015)





APPENDIX

Evolution of our assessment of Brazil's outlook:

Variable	<u>April 2015</u> “Brazil: Mounting Imbalances Require Political Will”	<u>March 2016</u> “Brazil: Approaching An Inflection Point”	Bienville Current Assessment
Growth	“Economy in recession, no clear growth catalysts”	“Now in the worst recession since 1901”	Economic “green shoots” as confidence increases
Inflation	“Now at 8.1%, above the central bank target, and could go higher”	“At 10.7%, the highest in 13 years”	Below 9% and falling. Expected to reach 4.5 – 5.0% by Q4 2017
Public Debt	“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%”	Could stabilize in the medium term on the back of Temer’s fiscal austerity and lower interest rates
Private Debt	“Potential for difficult nonperforming loan cycle”	“Higher likelihood of NPL cycle if economic activity remains weak”	NPL’s peaking while a lower cost of capital should alleviate debt burdens
External Accounts	“Current account deficit widening to 4.5% of GDP”	“Current account improving as FX adjusted, a positive”	Current account now positive as the trade balance adjusted
Currency	“Currency has devalued 40%, now closer to fair value (3.1 per USD), but downside risks remain”	“ <i>Real</i> has arguably overshot, reaching 4.2 per USD before strengthening modestly”	<i>Real</i> has rallied back to 3.25 after overshooting to 4.2
Investment	“Investment has continued to fall”	“Investment has continued to be very weak”	The new government is pushing infrastructure investment agenda



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