PICTET WEALTH MANAGEMENT

Brazilian elections

Lula emerges victorious but faces a divided Congress

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AUTHORS

JEAN-PIERRE DURANTE
jdurante@pictet.com

JULIEN HOLTZ
jholtz@pictet.com

LAURELINE RENAUD-CHATELAIN
lchatelain@pictet.com

LUC LUYET
lluyet@pictet.com

FLASH NOTE

SUMMARY

- On 31 October, Luiz Inácio Lula da Silva (Lula) was elected Brazil's president for the third time in a tight and highly polarising runoff against the incumbent, Jair Bolsonaro.
- Lula, a leftist, will nonetheless have to compose with a divided and right-leaning Congress where the amorphous political bloc called Centrão will act as legislative kingmaker.
- Lula inherits a country with healthy economic fundamentals, but also long-standing weaknesses — notably a chronic current account deficit and high public debt — that will constrain the new administration.
- The end of electioneering, elevated real yields (above 5% for government bonds), and a likely end to rate hikes by the central bank could be a boon for local and foreign investors alike. Nevertheless, the new government will quickly need to prove it is serious about tackling Brazil's large public debt, failing which we could see heightened capital outflows.
- We are keeping our slightly cautious view on the Brazilian equity market (especially relative to local sovereign bonds), which may have limited potential, especially given the uncertainty surrounding future earnings.
- We see limited upside for the Brazilian real as key factors such as the central bank's monetary policy stance, commodity prices and the fiscal outlook may turn less supportive going forward.

LULA ELECTED FOR A THIRD TERM

After leading opinion polls during the entire campaign (although the race was closer than expected), Luiz Inácio Lula da Silva (Lula) won the runoff of Brazil's presidential election with 50.9% of valid votes on 31 October, thus sealing a dramatic comeback for a man who was at the helm of Brazil from 2003 to 2010.

Jair Bolsonaro, the first Brazilian president to be voted out of office, remained silent for two full days after the results before addressing his supporters in a succinct and carefully worded speech. While he refrained from conceding defeat, he vowed to respect the constitution and authorised the start of the transition period.

Protests erupted after the final election results, with pro-Bolsonaro truckers and other individuals blocking highways and key city connections. While these protests may linger, partly due weak pushback from Bolsonaro, we would expect the movement to fade as governors mobilise security forces and pressure grows from a public worried about food and fuel shortages.

Beyond the specific local context, Lula's win mirrors similar recent moves to the left in other Latin American countries such as Chile, Peru and Colombia.

At the same time, the narrowness of Lula's victory underscores how polarised Brazil has become. Lula will also need to deal with a divided, right-leaning Congress in which the Centrão—a loose grouping of political parties without a consistent ideological orientation—will act as legislative kingmakers.

There is much unclarity about Lula's economic programme, although he did mention the goal of increasing real wages, reducing families' debt burdens, lowering income inequality and other economic measures in his first post-election speech. At the same time, his references to the need for credibility, stability and predictability are likely to have soothed financial markets anxious about Brazil's fiscal standing. The make-up of the incoming government in the coming weeks, and particularly of its economic team, will be of special importance to markets

WILL LULA REPEAT HIS PAST PERFORMANCE?

The relatively positive market reaction in the first days after his election (Bovespa +2.2% in local currency and real +2.8% against US dollar) indicates that a Lula presidency does not scare financial markets. Lula's economic record during his two previous stints as president may explain why they are willing to give him the benefit of the doubt for now. During his two tenures (2003-2006 and 2007–2010), the Brazilian economy grew by an yearly average of 4.1%, the unemployment rate dropped from 10.5% to 5.3%, inflation declined from 12.5% to 5.9%, the value of the real more than doubled against the dollar (3.6BRL to 1.7BRL) and the primary fiscal balance (i.e. excluding debt servicing charges) remained comfortably in positive territory (+3.1% of GDP on average) despite the global financial crisis (GFC).

In part, Lula was helped by the relatively sound economy he inherited from Fernando Henrique Cardoso, Brazil's president from 1995 to 2002, and in part by the commodity supercycle (at least until the GFC struck in 2008). The image of public-sector profligacy attached to Lula's party, the Partido do Trabalhadores (PT), is rooted in the dramatic deterioration in economic fundamentals during the presidency of Dilma Rousseff from 2011 to2016. During those six years, there was zero GDP growth, the unemployment rate jumped from 5.3% to 11.9%, the primary

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fiscal balance turned negative (from +2.6% of GDP to -2.5%) and the value of the real against the US dollar halved.

Jair Bolsonaro's economic record from 2019 to 2022 is relatively good using the same metrics considering that he had to deal with the pandemic and an energy crisis. Average annual real GDP growth was modestly positive (1.3%), the unemployment rate declined (from 11.7% to 8.7%), and the primary balance improved from -1.5% of GDP to +1.4% (despite a plunge to -9.4% in 2020). At the same time, inflation jumped from 3.7% to 7.2% (but this is a relatively mild increase in the context of a global inflationary shock) and the Brazilian real depreciated against the US dollar (from 3.9BRL to 5.3BRL for 1 USD).

A HEALTHY ECONOMY, BUT SOME FRAGILITIES

Lula inherits an economy with relatively sound fundamentals. Despite the looming threat of a global recession, the Brazilian economy was still growing at an annual rate of 3.2% in Q2 (and a rate of 5.0% annualised quarter-on-quarter). But leading indicators are pointing south. While still showing expansion in activity (unlike many countries, notably in Europe), the purchasing manager index (PMI) for manufacturing declined to 50.8 in October from 54.2 in May.

The unemployment rate dropped to 8.7% in Q3 22 (from 14.9% in March 2021), in part due to 'last minute' public programmes ahead of the presidential campaign. This should help support private consumption, which has remained quite resilient (1.6% y-o-y in August) despite the inflation shock. The recent bounce in consumer confidence (88.6 in October from 75.5 in May) also tends to support this idea.

Disinflation should also help as the consumer price index (CPI) has contracted month over month in the last three months. Annual inflation may have peaked in April, when it stood at 12.1%, compared to 7.2% in September.

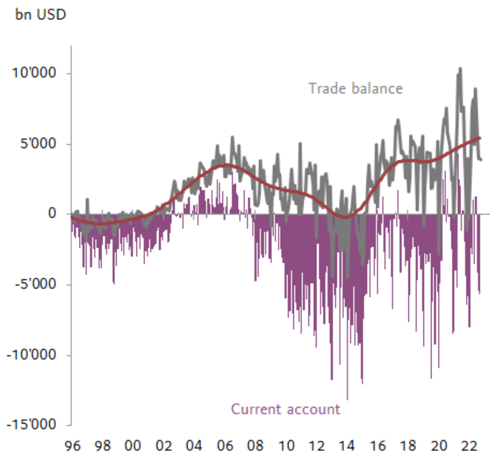
Thanks to a competitive currency, the Brazilian economy has recorded substantial trade surpluses since 2016 (USD51.6bn year-to-end-October, 61.4bn in 2021). The surge in commodity prices is supporting the terms of trade (export vs import prices) and thus Brazil's external surpluses. A reopening of the Chinese economy in 2023 could also help boost demand for Brazilian exports, especially commodities.

The Brazilian economy's Achilles heel remains the chronic current-account deficit, which increased to -2.2% of GDP in the first nine months of 2022 from -1.7% in 2021). Brazil's continued trade surplus is unlikely to fully compensate for the expected deterioration in income resulting from higher interest rates.

High interest rates will also weigh on the amount Brazil pays for debt servicing. As a result, the public deficit is likely to increase despite a comfortable primary surplus. Combined with slowing economic activity, public debt should increase. For these reasons, the new administration will have limited fiscal room for manoeuvre.

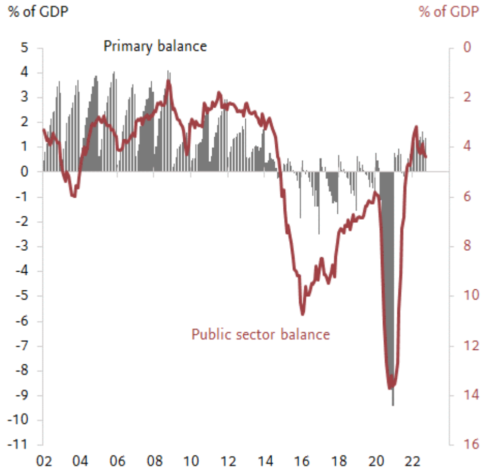
All in all, the recent favourable developments on the inflation front could allow the Banco central do Brasil (BCB) to be one of the world's first major central banks to start cutting rates. This could provide some fresh air to a decelerating economy and help limit the deterioration in the current account and government finances. However, given its limited fiscal room, the first moves of Lula administration's will be closely watched, with any deviation from orthodox policies likely to be sanctioned by capital outflows.

Chart 1: External accounts



Source: MDIC, Refinitiv (as of 03.11.2022)

Chart 2: Public sector balance



Source: Banco central do Brasil (03.11.2022)

SOVEREIGN BONDS LOOK SET FOR HIGH RETURNS

For the second time in a row, the BCB decided to hold its policy rate steady at its October policy meeting. **Having already hiked the Selic rate to 13.75% and with inflation recently moderating, we expect the BCB keep this rate steady over the coming months**, probably until H2 2023. As shown by the surprising strength of the Brazilian real against the US dollar this year, the BCB's early decision to raise rates (it started hiking rates in March 2021) has borne fruits without triggering a recession.

The possibility that the BCB may have reached a peak in the policy rate has led Brazilian government bond yields to fall below the Selic rate in local-currency terms, with the one-year and ten-year yields standing respectively at 13.09% and 12.10% on 3 November. As of 3 November, the sovereign bond market was pricing a Selic rate close to 12% in two years' time, corresponding to about 175 bp of rate cuts. We suspect that a fiscally responsible new government coupled with a halt in the US Federal Reserve's (Fed) hiking cycle in 2023 could even open the door for more rate cuts than are currently being priced in. But this largely depends on inflation continuing its downward trajectory and the real not depreciating significantly against the US dollar.

Although, foreign investors seem to have been reluctant to pile into Brazilian bonds in the first part of 2022, **the end of the electoral cycle, elevated real yields (over 5% on government bonds after inflation), and a likely end to the BCB's hiking cycle could prove strong tailwinds for foreign and local investors alike**. Nevertheless, the new government will first have to prove that it is serious about ensuring Brazil's large public debt remains sustainable over the long term.

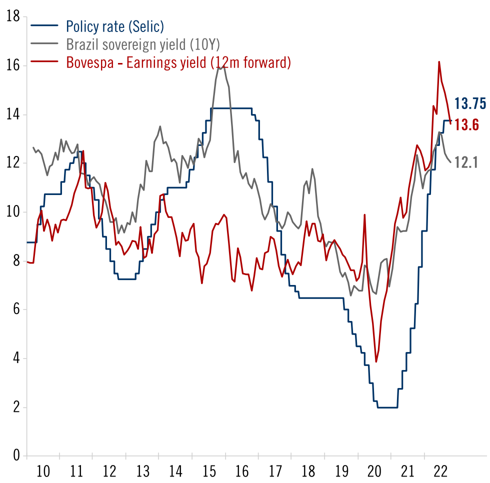
EQUITIES' UPSIDE COULD BE LIMITED

Up 21% in USD terms year-to-date (to 3 November), the MSCI Brazil index has outperformed both emerging (EM) and developed (DM) equity markets by a wide margin. While a strong currency provided some support, the bulk of this performance has come from steadily rising earnings on the back of high commodity prices and local interest rates.

Indeed, financials, materials and energy companies account for 65% of the MSCI Brazil's market capitalisation and almost 90% of its earnings. Hence, average earnings per share for the MSCI Brazil are now 37% higher in USD terms and 78% higher in BRL terms than their pre-covid level. Analysts are sceptical that such levels can hold, and so are we. With China sticking to its zero-covid policy, global economic indicators steadily deteriorating and Lula's administration potentially pressurising Petrobras to limit domestic oil prices, earnings are likely to stagnate at best.

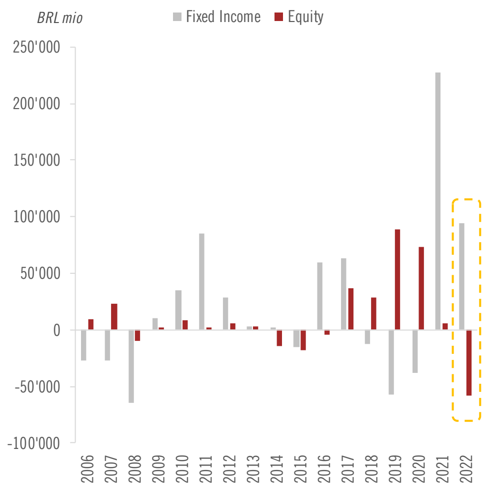
Granted, valuations close to all-time lows (the 12-month forward price-to-earnings ratio stands at 7.0x for the MSCI Brazil) provide a comfortable buffer in case of earnings contraction next year. But other valuation metrics, such as the price-to-book ratio show limited upside compared to their 15-year average (~+7%). With an equity earnings yield (13.6%) comparable to the policy rate (13.75%) and the 10-year sovereign local currency yield, and coupled with a BCB signalling the end to its hiking cycle, we see local investors continuing to favour fixed income over equities, a phenomenon that has accelerated over the past year.

Chart 3: Bovespa earnings yield



Source: Factset (as of 03.11.2022)

Chart 4: Flows into local mutual funds



Source: ANBIMA (September 2022)

Foreign investors' appetite for Brazilian equities will likely be driven in part by the make-up of the new administration and its policy direction (of which we know little so far). But equally important could be the impact that a potential recession in the US and Europe has on risk appetite generally.

All this explains our slightly cautious view on the Brazilian equity market at this juncture. We see further near-term upside as limited and are keeping our long-held year-end target for the Bovespa at 115,000, in line with current levels). Apart from the new government's policies, the timeline for an end to China's zero-covid policies will be key to watch, especially when it comes to commodity prices.

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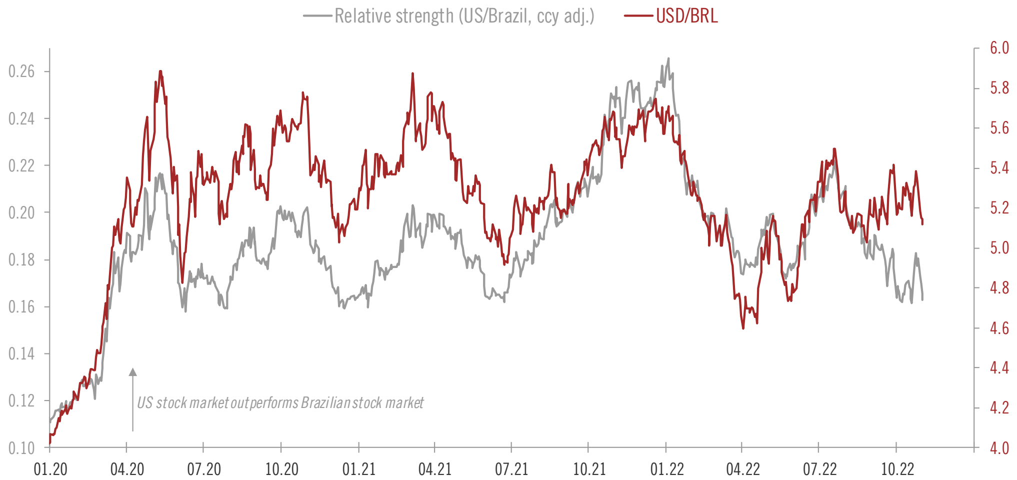
CONDITIONS FOR CURRENCY STRENGTH MAY TURN LESS SUPPORTIVE

The Brazilian real has thus far outperformed all other major currencies this year, including the US dollar. Among the main factors for this outperformance are the BCB's aggressive monetary policy since March 2021 and high commodity prices, which have helped Brazilian equities and alleviated some concerns about the fiscal outlook. The significant undervaluation of the real at the start of the year (the BCB even had to intervene on the FX market last December to prop up the currency) has added to its attractiveness.

Looking forward, conditions are likely to turn less supportive for the real. The BCB has likely ended its tightening cycle and may start to cut rate in 2023, while commodity prices may struggle as the global economic outlook remains weak, thus weighing on the earnings of Brazilian corporates. The incoming president's eagerness to increase social spending may also clash with the strict fiscal rule (i.e. the spending cap), putting renewed strain on the country's main fiscal anchor. With the fiscal outlook already likely to deteriorate given high interest costs and slowing economic activity, debt sustainability remains a key risk for the real.

USD/BRL and relative strength of US-Brazil stock markets (currency adjusted)



Source: Refinitiv (as of 3 November 2022)

Externally, the strong signal sent by the Fed at its October monetary meeting that it will keep raising rates and that the terminal fed funds rate could be "higher than expected" should keep the US dollar strong. Overall, the real may find it hard to rise much further in the next few months from current levels (BRL5.10 on 4 November). In the medium term, however, the real could be supported by foreign inflows into the Brazilian debt market as long as concerns over the fiscal outlook abate.

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