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BRAZIL - KEEP CALM AND CARRY ON

A LOT OF GOOD NEW IS ALREADY PRICED IN

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SUMMARY

- Brazil's GDP growth outlook is improving, with expectations for 2021 above 5%.
- Having proved resilient during the second covid wave, the acceleration of the vaccination campaign should allow a steady reopening of the Brazilian economy.
- Encouraging data has been accompanied by inflationary pressures, prompting the central bank (BCB) to react swiftly and the market to price in an extra 200bps of rate hikes over the next three months.
- Political noise has been rising of late, with allegations of corruption emerging around contracts to supply covid vaccines. We expect the controversy to abate in the coming weeks.
- While rising growth prospects and cheap valuations make the current optimism around Brazilian equities understandable, we believe most of the good news is already priced in.
- Unexcited by the outlook for Brazilian equities for the rest of this year, we are downgrading our position to neutral despite a slight rise in our year-end target for the Bovespa to 130,000.
- The Brazilian real performed particularly well in Q2. It rose 13% against the US dollar and easily outperformed other EM currencies, thanks notably to an improving economic outlook and an increasingly hawkish central bank.
- However, we remain cautious about the real's prospects over the longer term because of Brazil's ongoing fiscal imbalances. Our projections for the USD/BRL rate are BRL5.10 in three months, BRL5.40 in six months and BRL5.70 in 12 months.

Macroeconomic picture: more growth, more inflation

Brazil's growth outlook is undoubtedly improving. Real GDP growth expectations for 2021 have skyrocketed recently, from around 3.5% just a few weeks ago to about 5% currently. The strong run in oil and industrial metals has provided a significant boost to Brazil's prospects given the country's tight correlation to the commodities cycle. Economic data for the second quarter, including retail sales and services activity, all show favourable dynamics. Industrial production, while soft recently, is nonetheless turning the corner after a difficult first quarter. The rise in purchasing manager indexes (PMI) in June (to 53.9 for the services PMI and 56.4 for the manufacturing PMI) point to further expansion in economic activity.

Incidentally, the second covid-19 wave that reached its apex in March-April showed the Brazilian economy becoming more resilient to the pandemic. This was corroborated by a Brazilian Central Bank (BCB) study that found a loosening of the relationship between economic activity and mobility numbers. In any case, the long and intense second wave is now past its peak, with a big decrease in the mortality rate facilitating further economic reopening.

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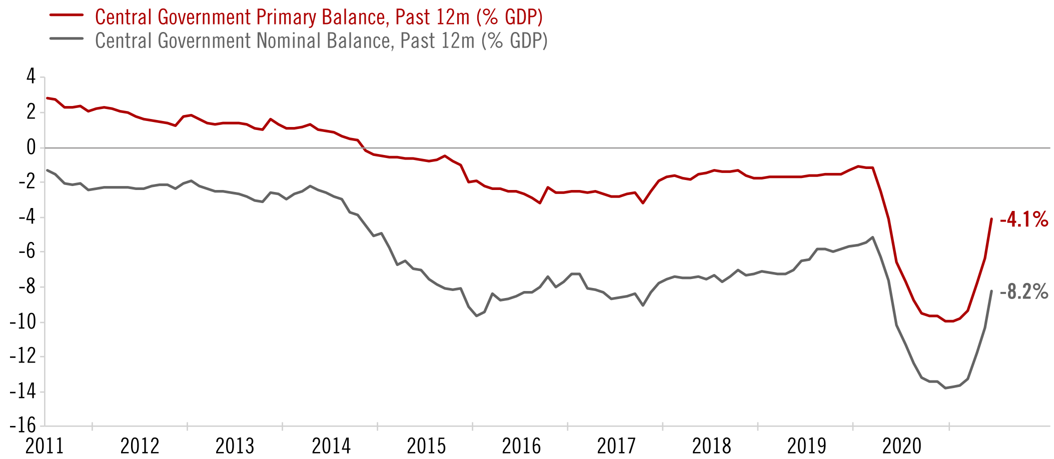
CHART 1: CENTRAL GOVERNMENT BALANCE (12-MONTH ROLLING)

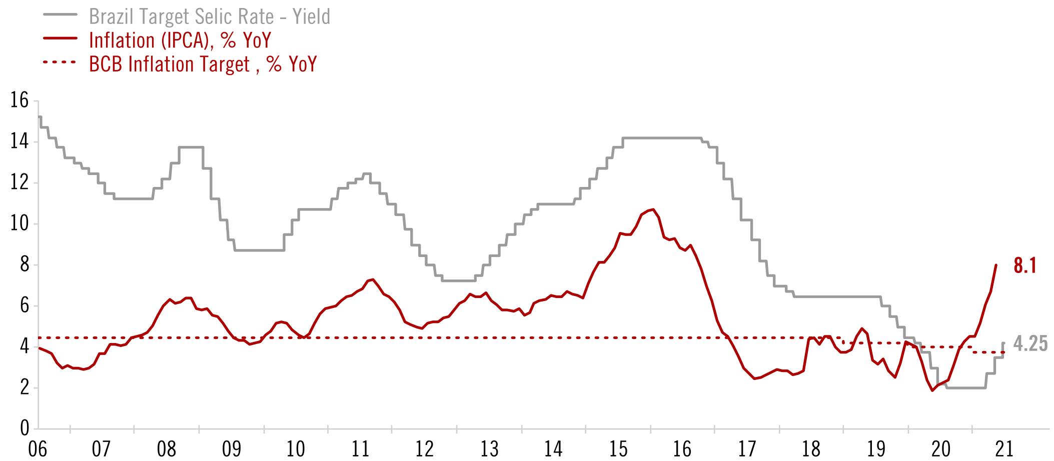


Source: PWM - AA&MR, Factset, 6 July 2021

This positive growth dynamic is reflected in the fiscal balance. Public finances are improving thanks to higher revenues (including transfers from mineral extraction) and lower pandemic-related spending compared to last year. The consolidated government primary balance is expected to be around -2% of GDP in 2021 compared to -9.4% in 2020.

The improved outlook for economic growth has been accompanied by persistent inflationary pressure, which is expected to peak this month and remain above the BCB's target until mid-2022. There is, however, a risk that the drought currently afflicting much of Brazil causes electricity prices to rise further and prevents food inflation from falling. To offset temporary price shocks and keep inflation expectations anchored, the BCB has progressively been moving away from the highly accommodative stance it adopted to deal with the pandemic. This may have consequences for growth in the medium term.

CHART 2: POLICY RATE (SELIC) AND INFLATION (IPCA)



Source: PWM - AA&MR, BCB, Factset, 7 July 2021

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Whirlwind in a bottle

Of course, Brazil wouldn't be Brazil without eventful politics. Of late, two cases involving negotiations of covid-19 vaccines have placed a question mark over President Jair Bolsonaro's anti-corruption credentials.

First, federal deputy Luis Miranda and his brother, Luis Ricardo Miranda, a civil servant, have claimed the latter came under atypical pressure to sign a BRL1.6 bn contract with India's Bharat Biotech despite several red flags. On Friday, 2 July, supreme court judge Rosa Weber gave the authorities 90 days to collect evidence to determine whether Bolsonaro was guilty of negligence in this case.

In a parallel investigation, Luiz Paulo Dominguetti, a representative of a medical supplies company, accused health ministry officials of requesting a bribe of USD1 per dose while negotiating vaccine supplies from Astrazeneca.

While the news led to protests last weekend and talks of impeachment, the head of the lower house of parliament Arthur Lira, said he currently sees no grounds to launch impeachment procedures. Stories of corruption may therefore impact president Bolsonaro's chances in next year's elections more than the length of his current mandate. Polling firm IPEC's most recent poll indicates that Bolsonaro's approval rating has continued to fall, to 24%, while left-wing populist Luiz Ignacio da Silva (Lula) is scoring twice as high of him in polls related to next year's presidential elections.

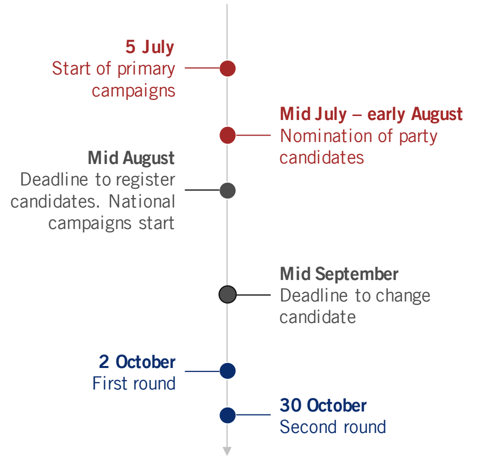
In this context, the government has extended emergency aid (dubbed 'coronavouchers') for low-income workers until October 2021. The plan is for these vouchers to be succeeded thereafter by a revamped 'Bolsa Familia' social welfare programme. Pressure from the street and critics from the left of the political spectrum could end up pushing Bolsonaro to act more decisively on this front before next year's presidential election (set to take place in October 2022). As usual in Brazil (and elsewhere), politics and public finances are closely intertwined.

FIGURE 1: 2022 ELECTIONS - OVERVIEW

Type	Who?	System
Presidential	President + VP	Two-round system
Gobernatorial	27 Governors & vice-governors (all states)	Two-round system (like Presidential)
Congressional		
Senate	27 seats (1/3 out of 81 total)	Majority voting
Chamber of Deputies	All 513 seats	Open list proportional representation
State Legislature	All seats (24 to 94 depending on state)	Open list proportional representation

Source: PWM - AA&MR

FIGURE 2: LIKELY TIMELINE (BASED ON 2018 ELECTIONS)



Source: PWM - AA&MR

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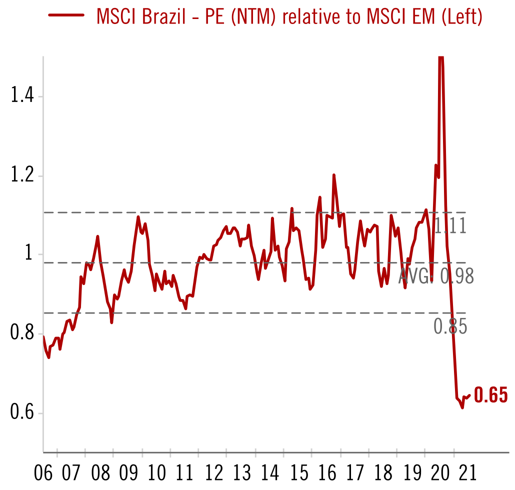
The red herring of cheap valuations

Optimism around Brazilian equities has been building of late on account of the improving growth outlook, economic reopening, strong earnings growth and cheap valuations. While do not disagree with this upbeat assessment, we believe that most of the good news is already priced in and that the apparent cheapness of Brazilian equities reflects some justified concerns over the medium term.

Since January 2020, earnings expectations (12-month forward, in USD) for the MSCI Brazil have increased by about 32%, whereas the price-to-earnings ratio has contracted by 36%, meaning that Brazilian equities' prices remain about 20% below their pre-pandemic levels in USD terms. However, they have risen by 11% in BRL terms, highlighting the magnitude of Brazilian real (BRL) depreciation.

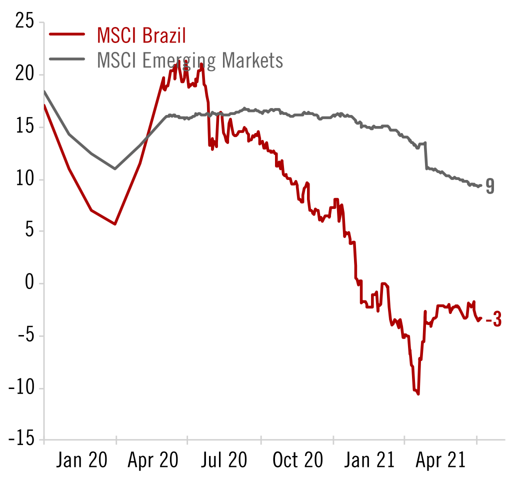
Part of the reason why Brazilian equities appear so cheap on an absolute basis is the meteoritic growth in expected earnings this year, of the order of 180%. But whereas earnings growth of this magnitude already looks to be priced in, earnings expectations for 2022 are much less rosy, with a contraction in earnings from the materials sector offsetting timid growth in other sectors.

CHART 3: MSCI BRAZIL – RELATIVE P/E (12M FORWARD)



Source: PWM - AA&MR, Factset

CHART 4: BRAZIL – 2022 EPS GROWTH (%)



Source: PWM - AA&MR, Factset

Without any year-over-year growth in earnings expected next year, any rise in future earnings expectations would need to come from analysts' revisions—but these have been slowing in local-currency terms since the end of May. Furthermore, our internal earnings per share (EPS) model based on policy rates and the BRL exchange rate points to stable EPS expectations at best by the end of the year (in USD terms), assuming constant commodity prices. In other terms, we see limited upside potential for earnings upgrades during the rest of the year.

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Price movements are therefore more likely to be driven by valuations, which may be affected by the rising political temperature. While CDS spreads suggest markets see political risk as remaining contained further out, current controversies could have an impact on confidence in Brazilian equities in the short term.

We also see a risk that a combination of monetary-policy normalisation and retreating inflation could improve the relative attractiveness of fixed-income instruments over equities, potentially interrupting local mutual funds' rebalancing towards equities.

Given significant political volatility in countries like Chile, Peru, Colombia and Argentina, we feel safer in the larger Latin American countries, which are either benefiting from increasing commodity prices (Brazil) or stimulus measures in the developed world (Mexico). Yet we remain unexcited by the outlook for Brazilian equities for the rest of this year in absolute terms and believe a lot of good news has already been priced in. We are therefore downgrading our position in Brazilian equities to neutral from overweight. However, we have adjusted our year-end target for the Bovespa up slightly to 130,000, reflecting a similar upside to what we expect for EM equities at large.

Bearish bias on the real

An improving economic outlook, a more hawkish BCB, higher carry, surging terms of trade as well as an improvement in external conditions (robust global risk appetite and fading upward pressure on long-term US interest rates in Q2) have all been boosting the Brazilian real.

The appreciation of the real from roughly BRL5.8 per USD in March to BRL4.9 in June reflects these improvements. With the BCB already signalling a Selic rate of 6.25% at the end of 2021 (compared to 4.25% today), we see monetary policy providing less upside to the currency in the months ahead. While the rise in Brazil's terms of trade might suggest further appreciation of the real, fading momentum in industrial metals prices could also limit the currency's upside potential. External conditions may turn less supportive of EM currencies in general in the months ahead, especially as our central scenario is for a renewed rise in US long-term rates. Higher US rates could weigh on global risk appetite, at least temporarily.

Another key driver of the real is the fiscal outlook. A probable decline in Brazil's debt-to-GDP ratio could help the real. However, the longer-term fiscal outlook remains very challenging. The lack of fiscal consolidation (because of the high political cost) and political uncertainties linked to the 2022 presidential elections could remain an important drag on the real. Overall, while we acknowledge that the real may outperform other EM currencies in the short term, we maintain a bearish bias in the longer term given Brazil's fiscal imbalances. Our projections for the USD/BRL rate are BRL5.10 in three months, BRL5.40 in six months and BRL5.70 in 12 months.

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