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INVESTMENT MANAGEMENT

Tales From the Emerging World

Brazil at a Turning Point

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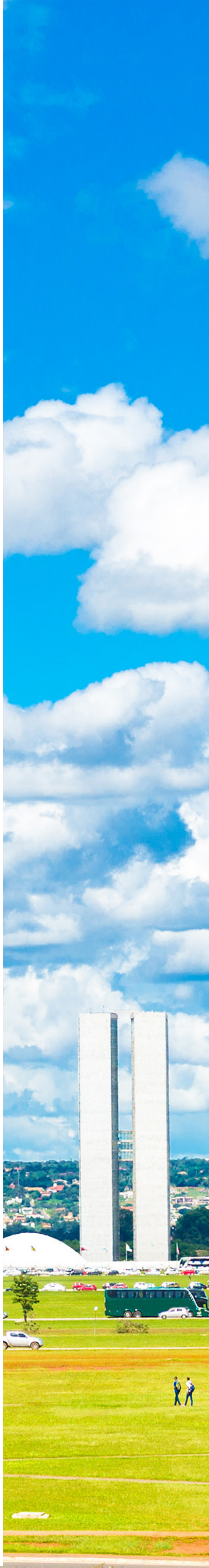
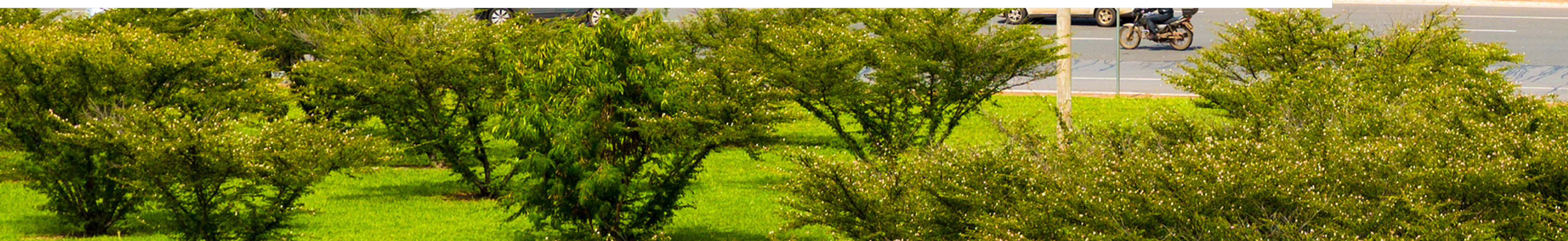
After his victory in Brazil's presidential election, Luiz Inácio Lula da Silva (Lula) began his victory speech with a simple message: "Brazil is back." The question investors are now trying to answer is: back to what? The answer depends on which version of Lula shows up. Will we see a return of the pragmatic Lula who, as president for the first time beginning 20 years ago, embraced responsible economic policies? Or will today's Lula act as a populist leader seeking aggressive redistribution? The answer will be the key driver for the Brazilian financial markets for the foreseeable future.

We recently visited Brazil and concluded that regardless of his recent push for populist measures, Lula remains constrained by a center-right Congress and a central bank laser focused on cutting inflation. Despite ambitious spending plans, we believe Lula will moderate his tone and ultimately implement reasonable economic policies. The path, however, will not be smooth as the market may end up "climbing a wall of worry." Brazil is currently benefitting from a booming agricultural sector *(Display 1)* and high commodity prices, leading to an improving trade balance and better growth. Additionally, economic reforms, such as pension and labor market reforms introduced under the previous administration, are starting to bear fruit. If the new government can successfully manage fiscal policy, interest rates can come down and the market should re-rate.

Observers had expected Lula to moderate his rhetoric after securing the keys to the Alvorada Palace, the president's residence. That hasn't happened. Since coming into office, Lula's call for more government spending, more state intervention and tougher regulations on business has unnerved investors. The new administration increased the number of ministries to 37 from 23, called on Congress to reverse recent privatization





plans, extended federal tax exemptions and pushed for tax and VAT reform. Lula even picked a fight with the Central Bank of Brazil (BCB), calling its interest rate of 13.75% "shameful." Investors fled as Brazil's stock market declined 14% since October 2022, compared with a 12% gain in the emerging markets during the same period.[1]

During his first two terms from 2003 to 2011, Lula toned down his ideological rhetoric and embraced pragmatic economic policies. The country's GDP grew by an average 4.5% annually, allowing Lula to leave office in 2011 with an 80% popularity rating. Brazil's per capita income under Lula's first two terms increased from $3,000 in 2003 to $13,000 in 2011. Today, it is $9,000, similar to what it was in 2008.

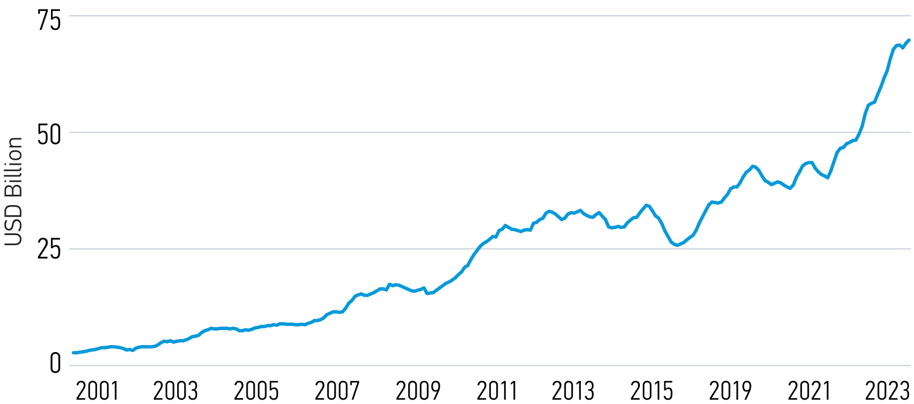
Of course, macroeconomic conditions during that decade were very different than today's, as Brazil benefited from a combination of favorable trends: soaring demand for commodities, as China embarked on massive infrastructure building, low interest rates and a sagging dollar.

After Lula stepped down, a series of corruption scandals derailed the administration of his protégé Dilma Rousseff, who was impeached in 2016. As the economy worsened, Lula himself was sentenced to 12 years in jail in 2018 for corruption and money laundering.

DISPLAY 1

Brazil's Agriculture Trade Is Booming

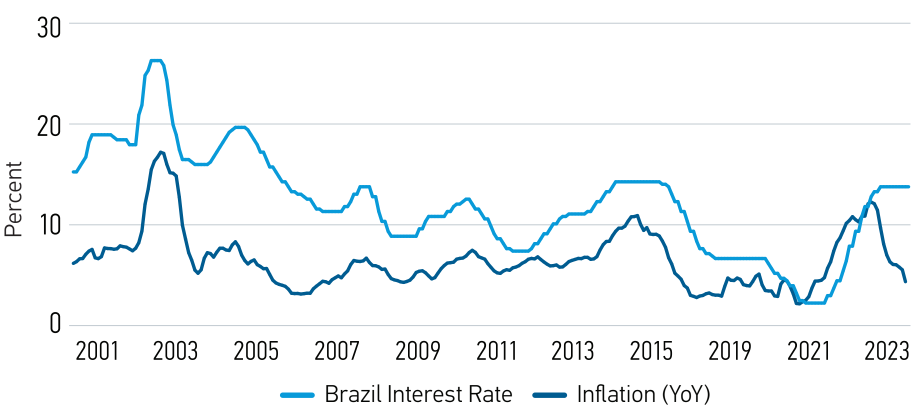
Brazil's annual agriculture trade surplus crosses USD 70 billion



Source: Haver, Bloomberg. As of April 2023.

DISPLAY 2

Aggressive Tightening Has Helped Brazil Lower Inflation



Source: Haver, Bloomberg. As of April 2023.

Yet, in a plot twist worthy of a top-rated telenovela, Lula was released after serving 580 days in jail when the Brazilian Supreme Court annulled his sentence in 2021, allowing him to run for president.

In October 2022, Lula squeezed out a win in a hard-fought election by promising a return to the prosperous days of his first presidency through greater government spending. His 1.8 percentage-points margin of victory was the narrowest in the country's history. Given his wafer-thin edge, Congress, now controlled by center-right parties, is in no mood to appease Lula's leftward leap. The administration can only count on about 200 allies out of a total of 513 in the lower house, leaving the president well short of the votes needed to unilaterally pass laws.

Yet the biggest impediment to Lula's expansionary plans is not the Congress, but the central bank, which retains its independence as evidenced by its decision to raise rates 12 times from a historic low of 2.0% to the current 13.75%, all designed to stanch inflation *(Display 2)*. The aggressive tightening helped lower inflation from a peak of more than 12% last year to 4.2% in April. While inflation still sits above the BCB's 3.25% target rate for 2023, we believe there is now a path to start cutting rates.

Timing is critical. Brazil has the highest expected real interest rates in the world (over 8.5% - *Display 3*) and the economy is slowing. Many of the administration's market-unfriendly policies have been ameliorated or quietly reversed. The banks rejected the government's populist cap on payroll loans, including the public sector institutions. Taxes on oil exports, designed to raise $1 billion in new revenue, proved to be unpopular and will not be renewed. The proposal to change the inflation target has also been dropped, despite the president's protestations.

The recently announced Fiscal Framework, now winding its way through Congress, signals that the administration is shifting its stance on improving fiscal balances. Under the new plan, which the Congress is likely to approve, spending can only increase by

[1] Emerging markets returns represented by the MSCI Emerging Market Index. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

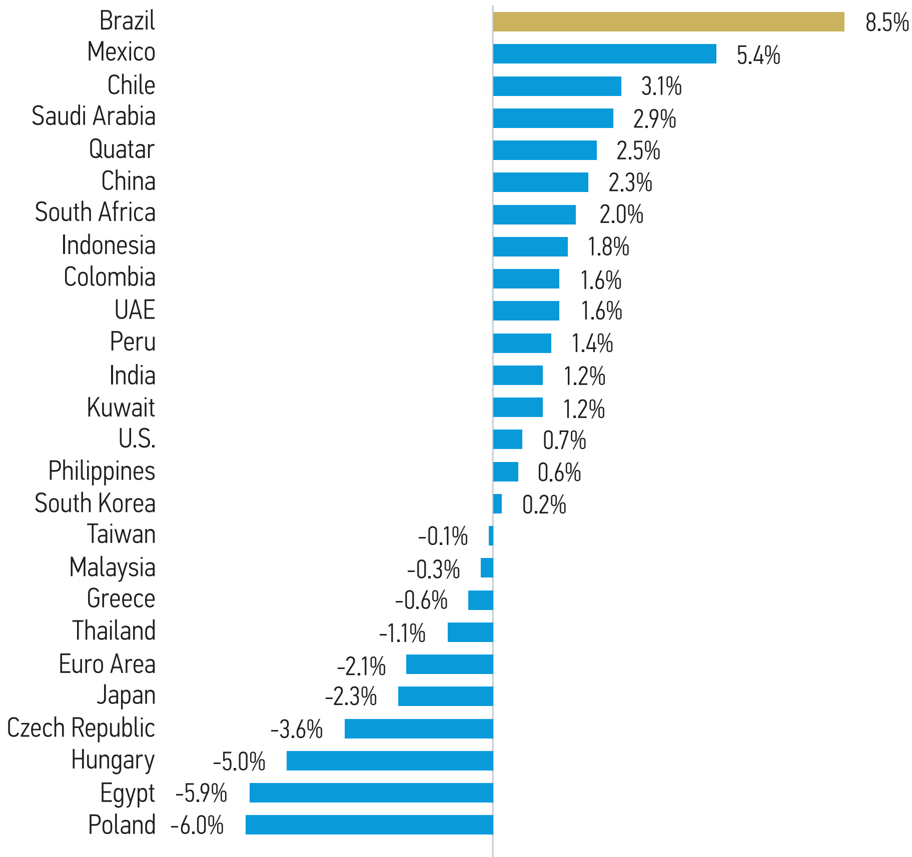
70% of revenue growth. For next year, the government set an ambitious goal to eliminate the primary fiscal deficit and then run primary surpluses, which would lead to a fall in government debt to GDP, currently at 85%.

That should help the BCB Governor, Roberto Campos, cut rates once the government's fiscal framework and a new budget have been approved by the Congress. Brazil's high interest rates have wreaked havoc on the stock market and brought about significant de-rating in multiples for companies. High real rates and a weaker economy have also hurt the most vulnerable members of the Brazilian population, Lula's core constituency.

After winning an election, a president typically switches from campaign mode to governing. Lula's current rhetoric is more akin to a politician looking to improve his popularity. Based on his past presidency we think Lula will rein in his populist pronouncements and pursue a reasonable fiscal policy. Once the BCB is convinced of this, the rate-cutting cycle will begin, which will lead to lower financing costs for corporations, prompting investors to shift from fixed income to the stock market and allow equities to re-rate.

DISPLAY 3

Brazil Has the Highest Expected Real Policy Rate in the World



Note: Expected real policy rate is defined as the current policy rate minus expected end-of-2023 inflation
Source: Haver, Bloomberg. As of April 2023.

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