GENERALI INVESTMENTS

Focal Point

Runoff in Brazil: Bolsonaro to win, but hard job ahead

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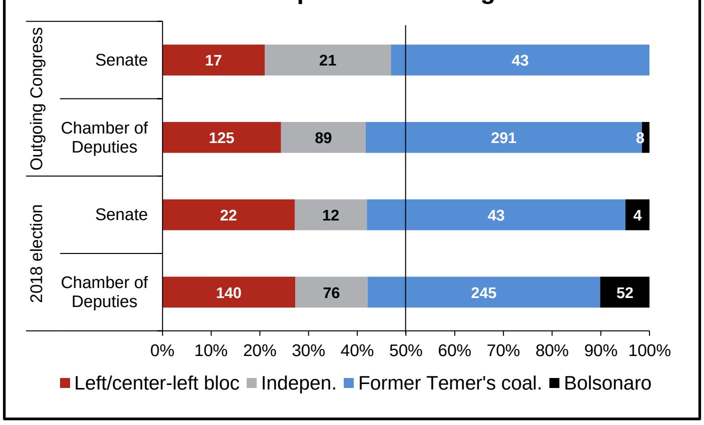
- Three weeks after the large victory in the first round of Brazil's presidential election, the right-wing candidate, Jair Bolsonaro, is expected to prevail in the runoff on Sunday over Fernando Haddad, supported by the left-wing bloc.
- Brazilian assets rallied markedly in recent weeks on expectations that Bolsonaro will approve the long-awaited pension reform and implement privatizations. However, Bolsonaro himself played down the possibility of selling strategic assets like energy generation, while the high fragmentation in the Congress may hinder the approval of the pension overhaul.
- After the recent rally, we see little value in Brazil's hard currency bonds, as the spread ratio vs Emerging Markets is at the lowest level since Jan 2015. The real (BRL) is still slightly cheap, but the risk/reward profile is now less attractive.
- Despite ongoing headwinds to EM equities in general, Brazilian stocks should benefit from fewer barriers on the way to expected reforms, a recovering economy, increasing margins and payouts and thus are expected to outperform EM.

On Sunday, Brazilian voters will choose the 38th president of the Republic. The right-wing Jair Bolsonaro is the front-runner and will face Fernando Haddad, who replaced former president Lula da Silva as the candidate of the left-wing Workers' Party (PT) after the Superior Electoral Court (TSE) banned Lula from running. Bolsonaro prevailed in the first round (held on October 6) with 46.0% of valid votes, nearly 17 pp ahead of Haddad (29.3%). According to the opinion polls released over the past week, Bolsonaro is leading by almost 20 pp.

With a comeback of Haddad seen as less and less likely, investors are focusing on Bolsonaro's ability and willingness to implement structural reforms (putting aside concerns over his controversial personality, pro-military inclinations and anti-minority tirades). We hereby analyze the key proposals of Bolsonaro's agenda, the hurdles faced by the Brazilian economy and then elaborate on the likely implications for Brazilian assets.

Will Bolsonaro fulfill his electoral promises?

Brazilian assets have rallied massively since mid-September from an earlier sell-off as investors have turned increasingly confident over a Bolsonaro's victory. The reasons for this positive attitude towards Bolsonaro are twofold. On a one hand, investors feared a reversal of structural reforms – including reduced regulation in the labor market, the cap on public spending, and stricter rules for lending activity by public banks – in case of a victory of the left-wing bloc. On the other hand, Bolsonaro's economic agenda pleased markets. He pledged to further strengthen the labor market reform and to reach a balanced primary balance already in 2019. Moreover, Bolsonaro's top economic advisor, Paulo Guedes, fueled expectations of a large privatization plan, possibly including Banco do Brasil and Caixa Econômica Federal – the first and third largest banks by assets in Brazil – and the oil and natural gas producer Petrobras.



Brazil: Composition of Congress

However, we are concerned that turning promises into facts will prove a difficult task. First of all, Bolsonaro's commitment to reforms looks ambiguous. As a congressman, he voted in favor to the spending cap and the labor market reform, but rejected the changes of the pension system proposed by the Temer administration. With regard to the reduction of the fiscal deficit, he suggested he would largely rely on oil field auctions, i.e. a one-off measure, to reach short-term goals. Moreover, Bolsonaro recently downplayed expectations of a large-scale privatization plan. He discarded the idea of privatizing public banks and also affirmed that state companies involved in energy generation are and will remain a strategic asset.

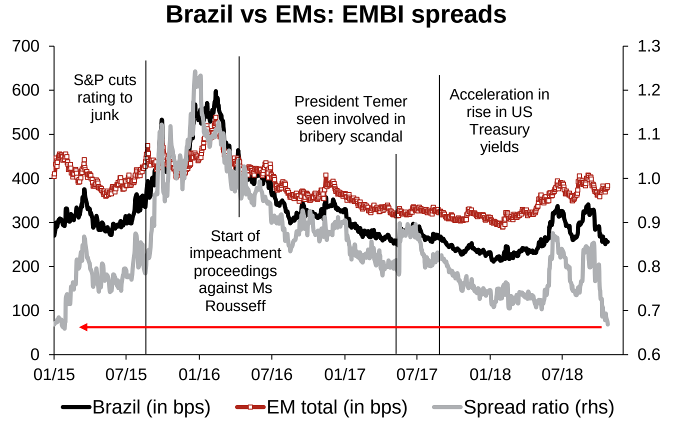
In addition, Bolsonaro will have to deal with the extremely high fragmentation in the Congress. His party (PSL) only controls 52 deputies (out of 513) and 4 senators (out of 81) and will have to secure the support of a dozen of different parties (or even more!) to implement his policy agenda. Reassuringly, the left-wing block controls less than 30% of total seats in both chambers and it is therefore unable to block structural reforms requiring a qualified majority of 60% (e.g. the pension bill). However, securing the parliamentary support for politically unpalatable measures may require a renewed increase in market tensions.

We believe that the fading market pressure since the ousting of president Rousseff in summer 2016 and the decline in refinancing costs – the central bank (BCB) has cut its policy rate from 14.25% to 6.5% over the past two years – have contributed to the slow adjustment in public finance and the failure to pass the key pension reform. While the current macroeconomic environment is relatively benign – real GDP growth will average 1.3% this year and we expect it to accelerate to 2.4% in 2019 –, Brazil will need to address soon the rising deficit in the social security system. The IMF warned that passing this reform is imperative, otherwise the pension bill would rise from 11.3% of GDP in 2015 to almost 14% by 2021, 17% in 2030 and to 29% by 2050.

Sovereign spreads do not factor in tail risks

In terms of market action, the rally in Brazilian assets is largely the result of a sharp decline in sovereign risk premiums. The 5-year CDS on Brazil peaked at 310 bps in early September after Lula da Silva was banned from running. It is now trading at around 215 bps, the lowest level since end-May. The reduction in sovereign risk premiums is even more significant if we consider the relative performance vs peers. The EMBI spread ratio between Brazil and Emerging Markets (EMs) is at the lowest level since January 2015, which is even more striking given the 3-to-4-notch downgrades suffered by Brazil since then.

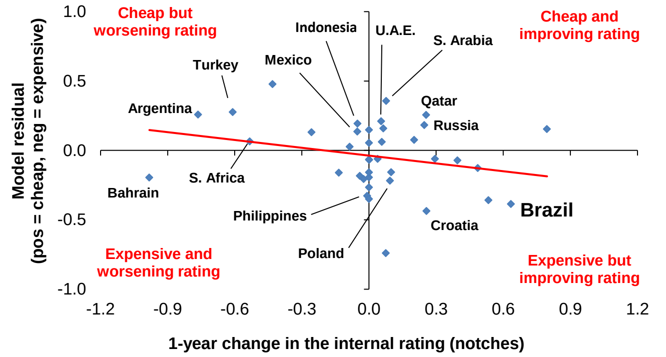
Brazil vs EMs: EMBI spreads



Also our relative valuation analysis, applied to USD-denominated EM sovereign bond spreads, suggests that Brazilian hard-currency bonds – in particular short-dated ones – are expensive compared to peers even after taking into account the improvement in economic fundamentals. Our internal rating (BB, with stable outlook) showed an improvement of 0.6 notches over the past 12 months. In our view, the expensive valuation of short-dated securities reflects the low refinancing risk thanks to the large stock of FX reserves (US$ 380 bn). That said, we prefer to wait for a better entry point as we see non-trivial risks of a spike in spreads should the market sentiment on Bolsonaro's ability to implement reforms start to fade.

Bond (USD) valuation & internal rating

Source: ICE Bofa External Sovereign Index, USD-denominated bonds
Data as of Oct 24, 2018. Model based on Bloomberg rating, duration.

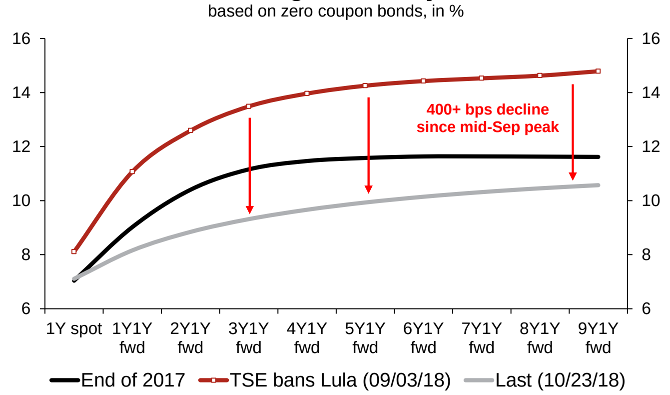


Bull flattening of local yield curve almost over

Local currency bond yields have also declined markedly. Again, the fall in sovereign risk premiums played a key role as it contributed to ease upward pressures on policy rates (market expectations for the SELIC rate at the end of 2019 declined by 150 bps since TSE's ban on Lula's candidacy) as well as long-term government bond yields.

Brazil: Sovereign forward yield curve

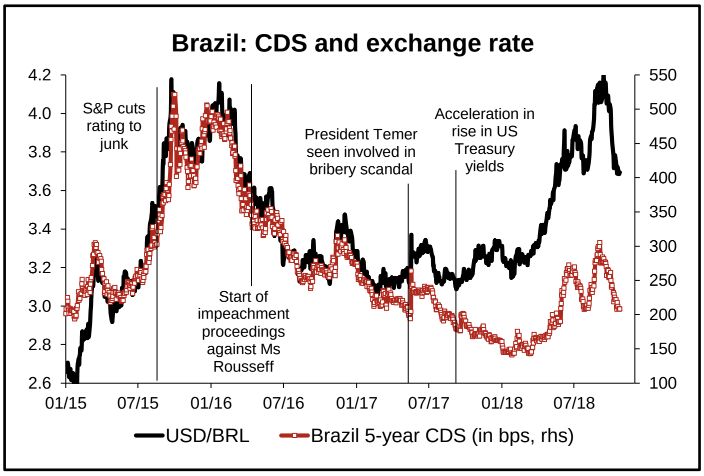
based on zero coupon bonds, in %



Given the expected normalization in core inflation from the current unusually low levels and the likely resulting tightening by the BCB (we expect cumulative hikes by 150 bps, from 6.50% to 8.00%, until end-2019), we believe the current bull flattening movement to be close to an end. The 2/10-year curve steepness has already declined from around 400 bps to 250 bps. This is still a remarkable level, but any further yield curve compression will most likely be the result of a bear flattening movement. Similarly to hard currency bonds, however, we see the risk of a repricing in sovereign risk premiums should Bolsonaro's policies fail to match investors' expectations. In that scenario, a bear steepening movement would occur, with the yield curve retesting the historical highs seen in early September.

BRL still slightly cheap, but smaller buffers now

After having depreciated by 21% against the US dollar since end-2017 (the third worst performance after the Argentine peso and the Turkish lira), the Brazilian real (BRL) rebounded sharply over the past six weeks. The USD/BRL exchange rate moved from 4.20 to around 3.70, a 13% appreciation for the BRL.

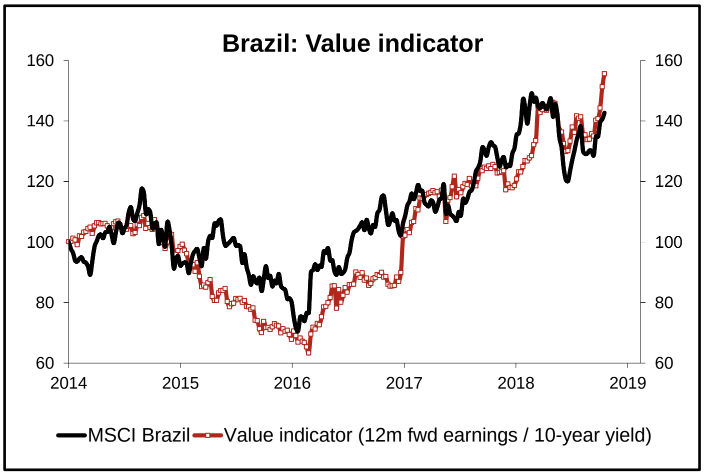


Our fair value model – which includes the EMBI spread ratio between Brazil and EMs, Brazil's external government debt to FX reserves ratio, terms of trade, oil prices and an index of policy uncertainty in Brazil – still points to a slight undervaluation (around 5%) against the US dollar. Indeed, the BRL seems to have lagged a bit the decline in sovereign spreads. That said, given the concerns we have on policy implementation, we prefer to maintain a neutral stance on the currency amid a still challenging environment for EM FX due to trade war fears and Fed rates hikes and since, at this stage, the buffers against downside risks seem too limited.

Equities to benefit from distinct country drivers

Since early September, Brazilian equities performed the best across all stock markets, gaining around 10% (or 25% in USD terms), contrasting negative to only slightly positive total returns of other stock markets. The rally is based on hopes of pro-business reforms under a Bolsonaro's presidency. In particular, state-owned companies perceived as possible candidates for the privatization program (e.g. Electrobras, Banco do Brasil) surged by more than 40%.

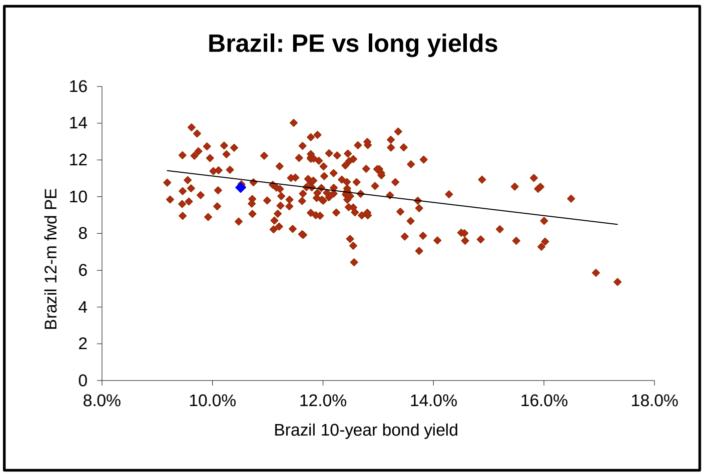
Despite the rally the Brazilian stocks seem to be somewhat undervalued compared to their value indicator based on fundamentals (earnings and 10-year government yields). Furthermore, their prices are lagging earnings expectations in absolute terms. Relative to EMs, though, Brazilian equity prices have developed in line with their earnings.



In terms of multiples, the MSCI Brazil is trading at a discount of 8.5% vs its history, whereas the EMs' discount is close to 20%.

In terms of conventional PEs, the Brazilian stocks seems to be slightly overvalued (10.5x vs the historical average of 9.25x) but this somewhat elevated level of PEs seems to be supported by the increasing expectations of the market's long-term earnings growth (currently at 15%). Furthermore, it should be noted that the much lower level of yields compared to history would justify higher PEs (see chart below).

The Brazilian economy is turning around while many of EMs are still experiencing an economic slowdown. Corporate margins and returns on equity (ROE) have started to in-crease and should support the market along with higher payouts. Based on our expectations of firmer economic growth, a slightly weaker Brazilian real (vs. USD) as well as oil prices of around 80 US dollar per barrel, we forecast an earnings growth of 19% in 2019. This is somewhat lower than the consensus expectations of 21.5% for Brazil but is still appreciably higher than consensus 2019 earnings growth of 11.6% for EMs in aggregate.



Geopolitical risks, trade war and contagion concerns along with slowing Chinese growth are likely to keep uncertainty elevated and represent a key reason to stay cautious in the near term on EMs. However, given the specific country drivers, we expect the Brazilian equities to outperform their EM peers over the next 12 months. Over the longer-run, the outlook for fiscal policy will likely play a key role, though. Should Brazil fail to implement the necessary reforms to put the debt-to-GDP ratio on a sustainable trajectory, risk premiums would inevitably adjust higher and also draw on the performance of Brazilian equities.

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