



Focal Point

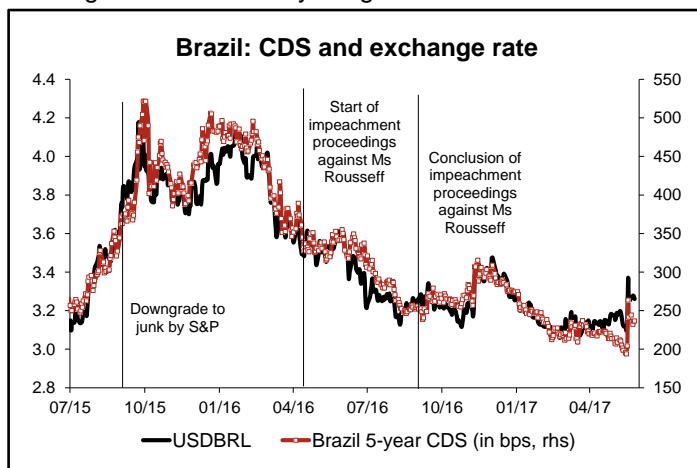
Brazil: A bumpy road ahead but reform push is not dead

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- On May 18, the news of President Temer being embroiled in a political scandal sparked the largest daily sell-off in Brazilian assets in almost a decade. The real (BRL) depreciated by 6.9% and the Bovespa equity index fell by 8.8%.
- Investors have become concerned again over the prospects of structural reforms. While the possible removal of President Temer could facilitate the approval of the crucial pension bill, the delay in its vote is weighing on sentiment.
- That said, we deem a repetition of the financial turmoil seen in H2 2015 as unlikely. Structural imbalances have eased and we expect the central bank to keep pursuing its easing cycle thanks to the far more benign outlook for inflation.
- Also, markets look constructive as Brazilian assets have already trimmed losses. Going forward, we see some value in hedged medium-dated local government bonds, while the case for hard-currency notes is less compelling compared to other EM bonds. Brazilian equities look unattractive as they lack support from fundamentals and valuation.

Less than two weeks ago, a report by the Brazilian newspaper O Globo reignited political woes in the country. According to a tape recording, President Temer apparently endorsed bribe payments to Eduardo Cunha, the jailed former speaker of the Chamber of Deputies, in order to secure his silence over the Car Wash scandal that had hit several eminent players of the Brazilian political class since 2015. Also Aécio Neves, the president of PSDB, the second largest party in the ruling coalition, was put under investigation amid bribery allegations.



Investors reacted abruptly to the negative news flow. On May 18, the Brazilian real (BRL) depreciated by 6.9% against the US dollar, the worst daily performance since July 2002. The Bovespa equity index fell by a whopping 8.8%, the largest decline since October 2008 while 5-year

sovereign CDS jumped by 60 bps to 264 bps, the highest level since early January. Local rates increased by almost 200 bps on medium and longer-term maturities, reflecting both a rise in sovereign risk and reduced expectations of interest rate cuts by the central bank (BCB).

In the last few days, Brazilian assets have partly recovered. Investors seem cautiously optimistic over the possibility that the crisis could be overcome, but visibility over political prospects remains low. We hereby analyze the likely implications for fiscal and monetary policy, before reviewing valuation and investment opportunities for Brazilian assets.

Pension bill on hold until Temer's removal

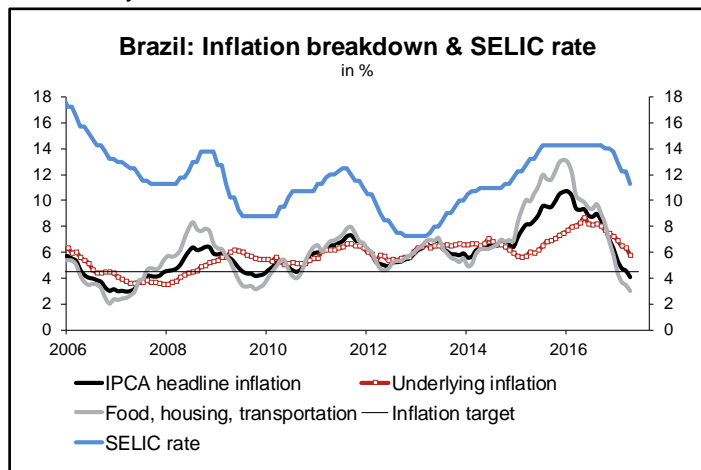
Before the new scandal went public, the approval rate for President Temer was already at single-digit levels. This was the result of the unpopular measures approved under his administration following the ousting of Ms Dilma Rousseff at the end of August 2016. Despite such a low public support, the reform momentum had remained intact and the Lower Chamber was expected to hold the first of the two votes on the pension bill by the end of May.

Unsurprisingly, the vote over the pension reform was delayed in order to allow the government to secure a sufficient margin of confidence over the 60% of votes required to pass the bill (which will also have to be ratified by the Senate). Passing the pension reform is seen as a vital step to restore debt sustainability over the longer run. Indeed, the IMF warned that without any change, 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.

Several parties of the ruling coalition, including PSDB and DEM – which control 76 seats out of 513 in the Lower Chamber – seem reluctant to keep backing Mr Temer and want him to step down before resuming the discussion over the pension reform. President Temer, however, firmly rejected any wrongdoing and has refused to resign so far. The opposition has already filed a couple of impeachment requests against him, but the proceedings could last for two or three months. A much faster solution could be offered by the Electoral Supreme Court (TSE), which can decide to void the 2014 elections amid funding irregularities in the electoral campaign, triggering the removal of President Temer. The TSE will convene on June 6 to examine such a possibility. Should the annulment prevail, the Brazilian constitution envisages an indirect election by the Congress to select the new president within 30 days. Direct presidential elections before the natural term (October 2018) would require a constitutional amendment. The negotiations among coalition parties have already begun and this, in our view, is a sign that the government coalition is willing to stick to its reform agenda. We assign a 60% probability to the approval of labor and pension reforms.

Central bank will remain a tailwind

The report against President Temer prompted an immediate repricing of investors’ expectations over the future course of monetary policy. The market-implied year-end SELIC rate rose by 110 bps to 10.08%, reflecting the risk that the BCB could slow down the pace of rate cuts after the 250 bps reduction – from 13.75% to 11.25% – already delivered year-to-date.

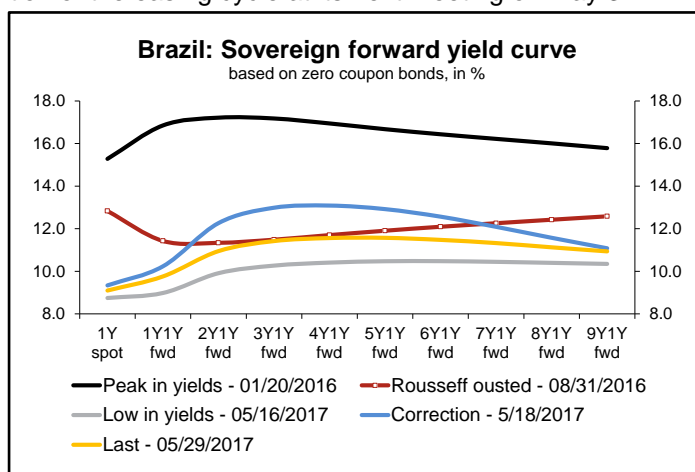


While the delay in the approval of structural reforms and the potential upward revision in inflation estimates amid a weaker BRL could warrant a less dovish stance, we believe that the BCB has scope to continue its easing cycle. The key reason for that is the benign dynamics in inflation. Unlike in late 2015 – when inflation soared to 10.7% yoy – price growth is now running below the 4.5% policy target (4.1% yoy in April) and we expect it to fall below 3% in the summer, before recovering gradually thereafter. High unemployment (13.3% in March, the highest level since 2006), the contraction in lending (down by 2.7% yoy in nominal terms in March) and the mild tightening in fiscal policy are all weighing on the economy, limiting endogenous inflationary pressures. In addition, the downside risks to the incipient recovery could further weigh on longer-term inflation expectations, offsetting the impact of the limited depreciation of the BRL seen so far. We expect a 0.3% expansion in real GDP in 2017, following a cumulative

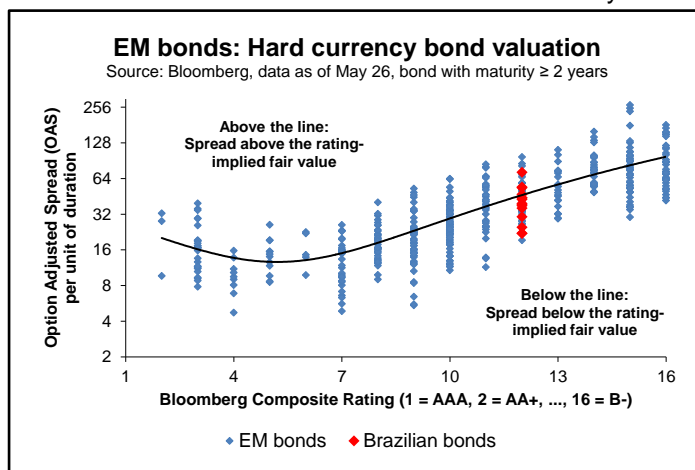
9.0% contraction since Q1 2014. As a result, we foresee the BCB to reduce the SELIC rate to 8.5% by year-end, though we acknowledge the risk of a less frontloaded process. The likely continuation of the easing cycle will benefit public finances, given that 44.6% of Brazilian government debt is linked to the SELIC rate.

Some value in medium-dated hedged local bonds

The repricing in the future course of monetary policy and the spike in risk premiums have significantly weighed on local government bonds. Medium- and longer-term bond yields rose by up to 200 bps in the immediate aftermath of the news about Mr Temer’s bribe payments. While rates have already fallen thereafter, the yield curve looks very steep until 5-year maturities, suggesting opportunities in medium-dated bonds. A EUR-hedged 5-year Brazilian bond could offer a pickup of 250 bps over German Bunds, with a further potential in terms of price appreciation, especially if the BCB reassures investors over the continuation of the easing cycle at its next meeting on May 31.

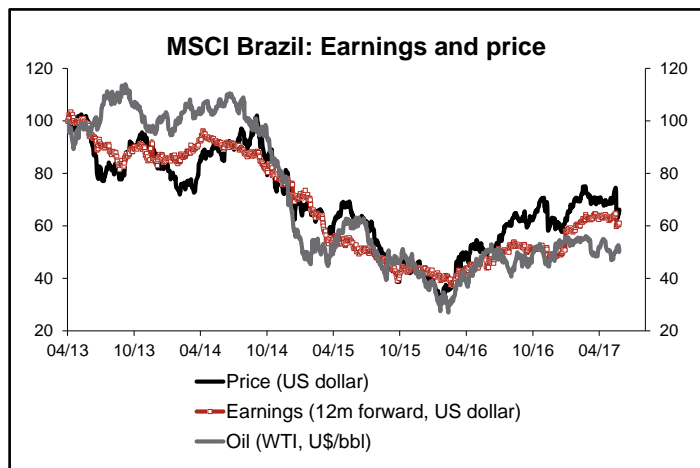


On the other hand, the case for hard currency bonds looks less compelling when considered for mark-to-market strategies. While high FX reserves (US\$ 376 bn) make hard currency bonds reasonably safe for buy-and-hold investors, our relative valuation analysis suggests that Brazilian bonds are somewhat expensive – with the sole exception of short-dated ones, i.e. those with a maturity of 4 years or less – when compared to other emerging market notes with a similar rating. We consequently recommend increasing the exposure only in case of a renewed spike in risk premiums. The same is true for the BRL, which has almost perfectly matched the movements in the 5-year CDS since the first round of the crisis started in July 2015.



Equities: dear, not supported by fundamentals

In terms of investment focus, Brazilian equities have represented 'the hot EM'. Despite the challenging macroeconomic environment, the Brazilian stock market has shown the best total return performance (67% in local currency terms) across all markets and has outrun the EMs in local currency by 27 pp since the end of January 2016 when market participants had started to bet on the turnaround of the Brazilian economy. Brazil's equity volatility has been at the same time more than twice higher than the average of the EMs.



While the investors' expectations of the economy coming out of the recession have not been unjustified and the stock market has been fueled by increasing earnings expectations (as a result of increasing oil prices and lower yields) and later higher corporate profitability, the strong bull market in 2016 pushed Brazilian stocks into rather expensive territory causing the market to trade above fair valuation. Indeed, the market looks overvalued compared to its fundamentals (12-month forward earnings / 10-year yields). Likewise, the market's price trend has outrun its expected earnings trend. In this regard, it should be noticed that consensus expects the earnings to grow 27% in 2017 and 4% in 2018. Our macroeconomic model based on real GDP, the exchange rate, oil prices, and exports supports the lower 2018 estimate but indicates that consensus earnings growth for 2017 would be hard to achieve. We deem 14% to be a more realistic projection, which will likely put pressure on the market towards the end of the year.



Furthermore, the market is quite expensive by the conventional 12-month forward PE, which is currently at 12.1 and

is more than one standard deviation above the historical average of 8.8. Under the current market conditions (Brazil's vulnerable economy, political uncertainty, and comparatively lower profitability), the market should be priced with a discount, not a premium. Finally, neither in absolute terms nor relative to the EMs (see bottom chart) is the lower long-term earnings growth of 8.7% supportive for high PEs.

In conclusion, we expect the political process ahead to be long, complex, and painful. Exposure to Brazilian equities should be avoided unless the political risk settles down. We recommend waiting for a better news flow or a major setback resulting into an undervaluation before stepping into the market.

Imprint

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