BRIC countries: how are they doing today? Part I - Brazil

Key Takeaways:

- Growth: After posting negative GDP growth for 8 consecutive quarters, the economic outlook has improved. Brazil posted a GDP growth of 1% for Q1 2017, 0.2% for Q2, and we expect a positive GDP growth rate for 2017.
- Politics: To achieve sustainable growth, Brazil will need to implement sweeping political and economic reforms.
- Recovery: We believe this period of economic and political turmoil is finally being left behind, with meaningful reforms being enacted as a consequence. We are confident Brazil represents, today, a tremendous opportunity for foreign investors.

Exposure to emerging markets constitutes an important strategic opportunity for U.S. investors. Yet with any investment, the reward and risk are directly related, In the case of those countries classified as Emerging Market, numerous economic and financial changes have occurred over the past decade. The financial crisis and the end of the commodities boom are two phenomena that affected emerging markets profoundly. In this series of papers, we focus our attention on the four most important emerging-market economies, considering both size and growth potential: Brazil, India, Russia, and China. Although Goldman Sachs originally bundled these countries together as the "BRICs"[1] more than 15 years ago, the economic and equity market performance of each of these countries has been significantly different. Understanding the drivers of both the economic cycle and market cycle is paramount to achieving investment success. Figure 1 shows the market volatility of the MSCI BRIC equity index. This market volatility provides the empirical evidence of the BRIC opportunity.

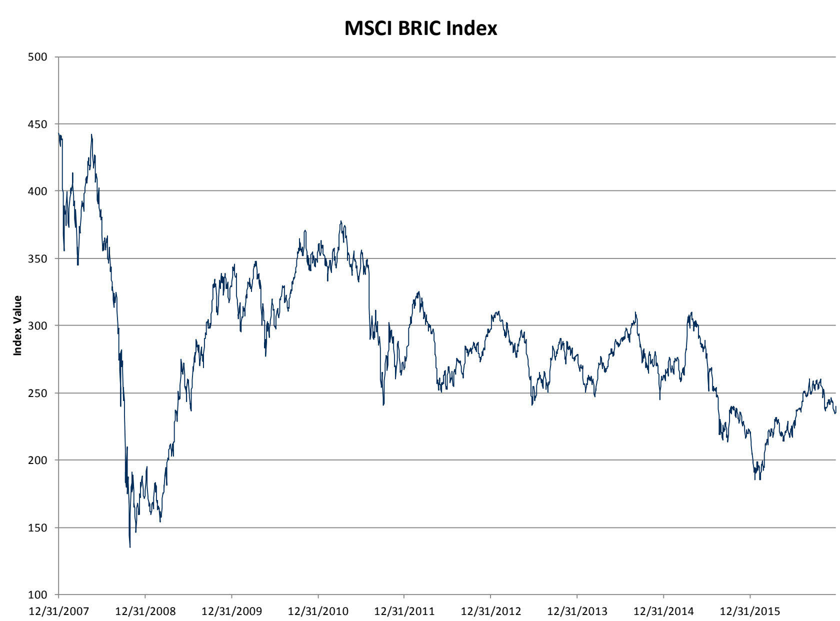
The series starts with Brazil. In the last two years alone, Brazil has witnessed a presidential change due to impeachment, a changing commodities environment, and a political push for economic reforms.

Figure 1

EQUITY MARKETS ACROSS BRIC COUNTRIES HAVE BEEN QUITE VOLATILE

Daily data between 12/31/07 and 12/29/16.

Source: Innealta Capital using data from Bloomberg.



1. A 2001 paper by Goldman Sachs coined the acronym BRIC for Brazil, Russia, India, and China. (Building Better Global Economic BRICs, Global Economics Paper No: 66, November 2001).

1. What went wrong?

Brazil is the fifth-largest country on the planet, by both land mass and population. Its economy is projected to become the eighth largest by the end of 2017 in terms of nominal GDP, according to the IMF. It is thus the third amongst the four BRIC countries, after China and India, and before Russia. In 2010, Brazil recorded its highest (real) GDP growth rate in 20 years: 7.5% (figure 2). Unemployment was at 7.4%, the currency was strong against the dollar (USD/BRL at 1.67), inflation was relatively low (5.91%), and the government ran a primary surplus (BRL 58 billion). Even after the financial crisis had severely damaged other economies, Brazil had found a way to weather the storm. Internal consumption was boosted with a combination of reduced interest rates and lower taxes. On the external front, the price of commodities (of which Brazil is a big exporter), like soya and iron ore, was also lending the country a hand.

But Brazil, just as other South American nations (e.g., Venezuela, Argentina, Chile), took a big hit when the commodities super cycle came to an end in 2014 (see figure 3). Prices for Brazilian commodities started falling in 2010, with China's reduced demand playing a big role. This hurt export revenues, which in turn depreciated the Brazilian real and put upward pressure on inflation. Capitals flowed out of the country, with internal and external factors to blame (amongst the latter, the increased probability of interest rate hikes in the US).

Figure 2

QUARTERLY GDP GROWTH IS POSITIVE AGAIN

Quarterly data between Q3 2007 and Q2 2017.

Source: Innealta Capital using data from Bloomberg.

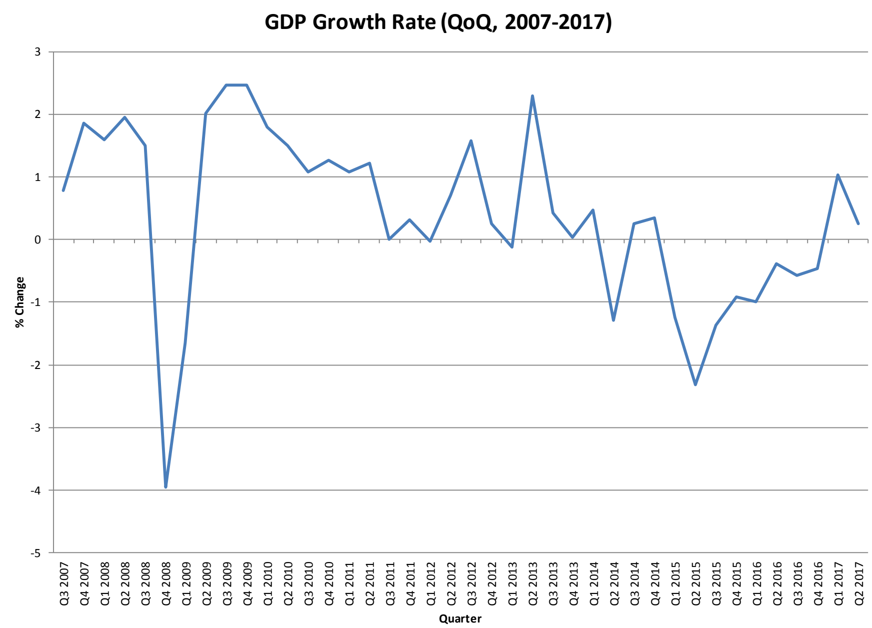
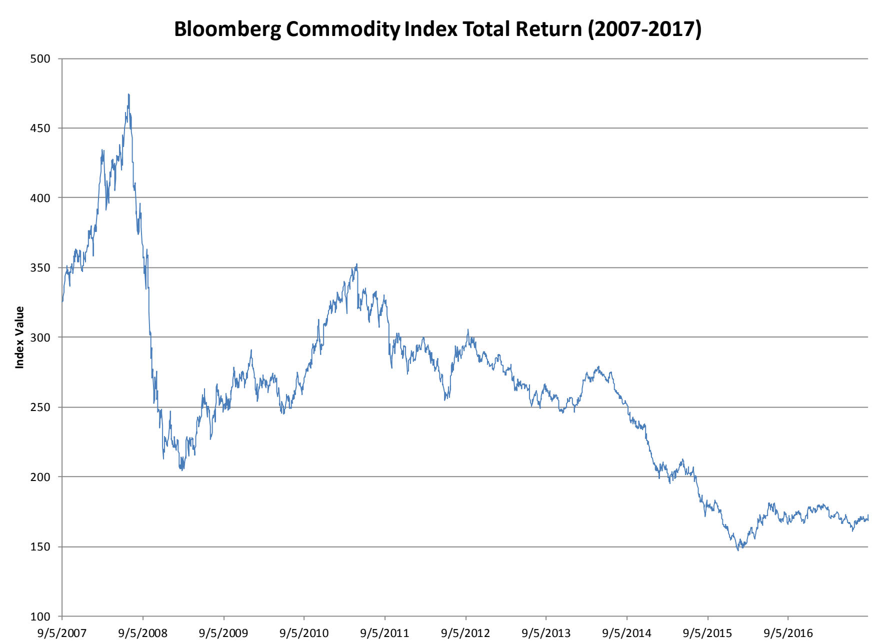


Figure 3

PRICES OF COMMODITIES HIT BRAZIL HARD

Daily data between 9/5/07 and 9/1/17.

Source: Innealta Capital using data from Bloomberg.



Furthermore, falling tax revenues squeezed the public coffers. This did nothing but worsen one of Brazil's biggest problems: the large amount of public debt, which now stands at 70% of GDP. (It grew by more than 11% in 2016, and almost by 22% in 2015.) Raising taxes is not much of an option, given that the tax burden already stands at 35% of GDP (see figure 4).

Figure 4

TAXES IN BRAZIL ARE NEAR U.K. LEVELS

Yearly data between 2007 and 2015.

Source: Innealta Capital using data from Receita Federal do Brasil.

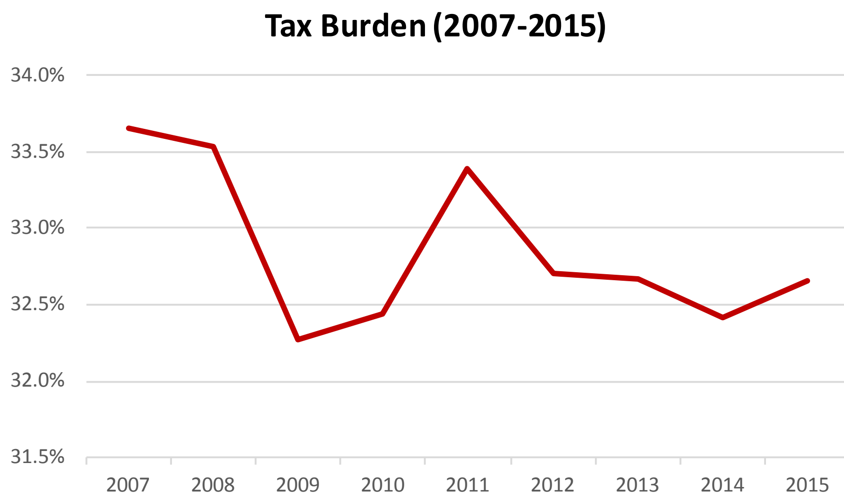
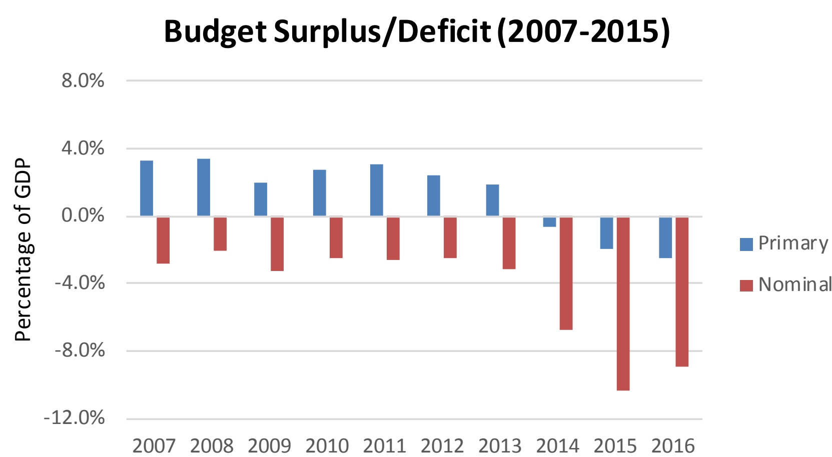


Figure 5

BRAZIL IS HEAVILY BURDENED BY INTERESTS ON ITS DEBT

Yearly data between 2007 and 2016.

Source: Innealta Capital using data from Central Bank of Brazil.



Additionally, Brazil's political system has been rocked to the core by various corruption scandals. The president herself, Dilma Rouseff, was impeached by the Congress of Deputies in April of 2016, and later removed from office by the Senate on August 31st of that year. Although she was not charged directly with corruption, but instead of violating budgetary laws, her ousting was preceded — and definitely motivated — by a corruption scandal of epic proportions at state-controlled oil firm Petrobras. This and other corruption revelations have cast big doubts about political stability, as no public official in a position of power seems immune to new revelations that will force them out of office.

After the president's ousting, Michel Temer, the vice-president, assumed the highest office. He is from a different and more business-friendly party than his predecessor. This has reignited hopes that much-needed reforms will be implemented. And to a certain extent, he has delivered (more details below). More importantly, he is pushing for even more. Despite the hurdles that deep reforms always encounter along the way, not since the late 90s have we seen such an ambitious plan for Brazil.

The end of the commodities bonanza, coupled with its own internal problems, took Brazil from its outstanding 7.5% GDP growth rate in 2010, to a recession that ended up being the worst on record. Only in 1930-1931 had the country experienced two consecutive years of negative growth (2.1% and 3.3%, respectively), but 2015-2016 was even worse (3.8% and 3.6%, respectively). All three big sectors (agricultural, industry, and services) posted negative growth rates in 2016. Gross fixed capital formation (GFCF, used as a measure for investment) was down by 10.2% in 2016, its third consecutive year in the red.

As a share of GDP, investment fell to its lowest level (16.4%) since it began being measured in 1996. Private consumption also decreased (4.2%), as did the government's (0.6%), but at least exports grew (1.9%). At the end of 2016, unemployment stood at 12%, the Brazilian real had lost almost half its value (USD/BRL at 3.25, see figure 7), and the primary surplus had turned into a deficit of BRL 154 billion ($49 billion, see figure 5). Along the way, Brazil lost investment grade status in 2015, which it had gained in 2008. Inflation is back to two digits (figure 6). On the bright side, this is also signaling that demand has not weakened as one might have assumed. In fact, nominal GDP has continued to grow.

Figure 6

INFLATION HAS RECEDED

Monthly data between 9/30/07 and 6/30/17.

Source: Innealta Capital using data from Bloomberg.

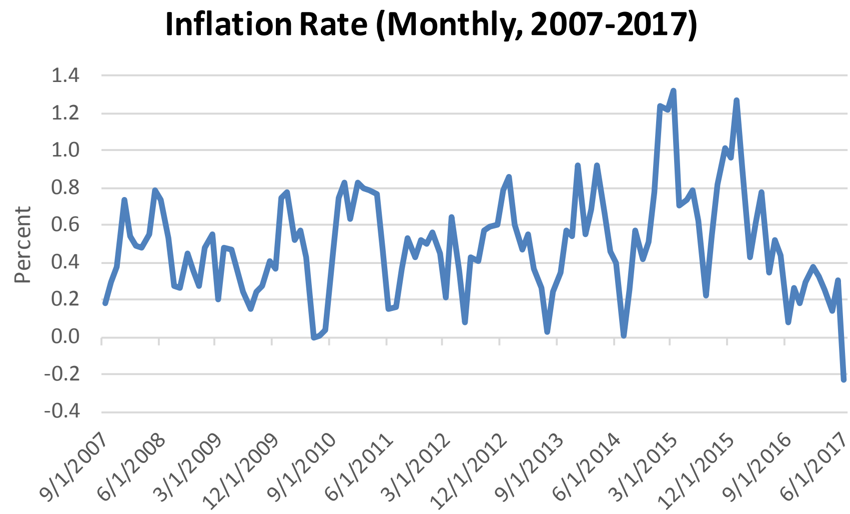
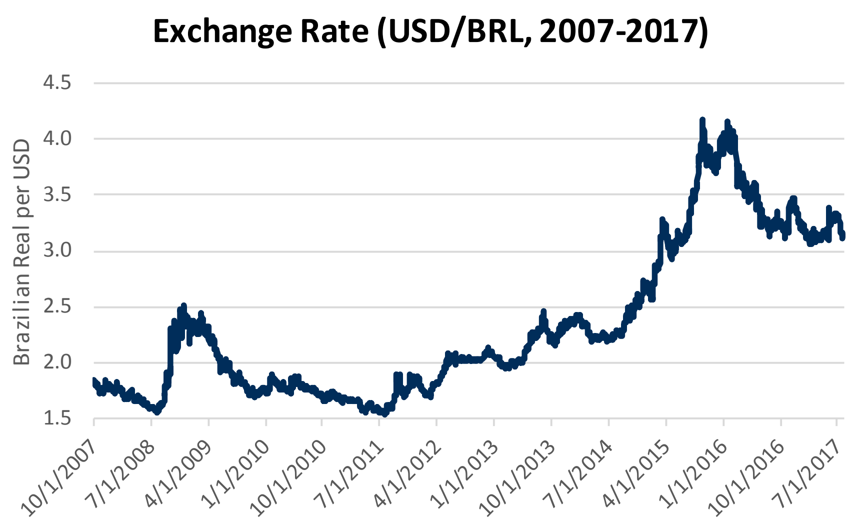


Figure 7

THE REAL HAS DEPRECIATED SUBSTANTIALLY OVER THE LAST FEW YEARS

Daily data between 10/1/07 and 7/28/17.

Source: Innealta Capital using data from Bloomberg.



2. Main challenges

We believe the worst of the economic and political crisis that has affected the country is behind. This does not mean, however, that all is well. There are still many areas that present both short- and long-term risks (and, therefore, opportunities) to Brazil's economic development. In this section we present a summary of the ones we believe constitute the main hurdles afflicting the country today. We also list the steps that have been taken lately by the authorities in order to address these problems. It is easy to see that progress has been made regarding many of them.

2.1. Debt

We share the opinion of many analysts that Brazil's main economic problem today is fiscal. In fact, it was the reason behind Standard & Poor's 2015 downgrading of Brazilian debt to junk status. Brazil's levels of public debt have been growing steadily. In 2016, the fiscal deficit reached 9% of GDP (see figure 5). While it is true that interest payments on the debt are significant, if we only take into account the primary deficit (which excludes interest payments), the numbers still look bleak. Government officials have stated that the country will have primary deficits until 2019, meaning 6 successive years of such deficits. It is expected that, when a new president takes office in January 2019, gross government debt will be north of 80% of GDP. The only factor alleviating this burden right now is the interest rate reduction on which the central bank has embarked since October 2016 (14.25% to 9.25% today, after several cuts; see figure 8). This has the added benefit of reducing the risk of default, encouraging investors to hold government bonds.

Although the recession is partly to blame, as it has squeezed tax revenues, there are structural problems the country will need to face at some point in order to control outlays. The main challenge at present is pensions reform. The government estimates that current spending on pensions is 13% of GDP, more than richer and older nations like Norway, Germany, and Belgium. With the senior share of the population expected to reach 1/3 in 2050, the current expenditure levels are clearly unsustainable (they would reach 23% of GDP in 2060, more than any country presently allocates to this item).

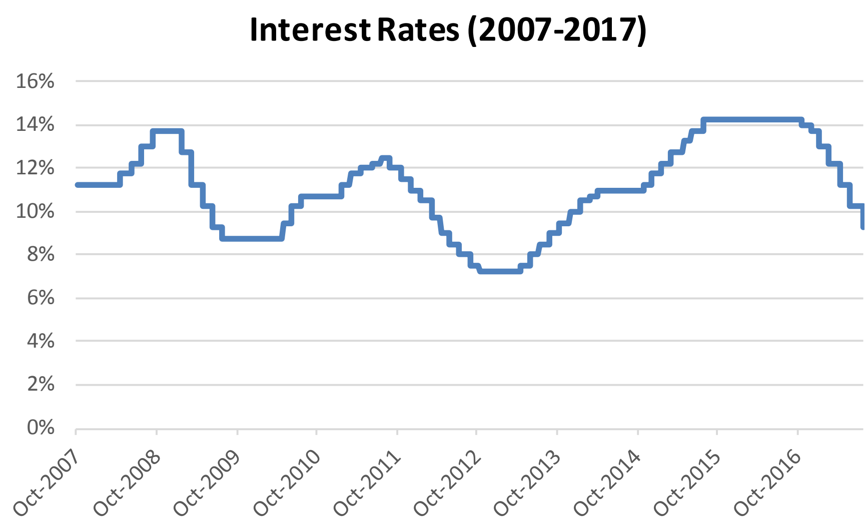
What has been done recently? A constitutional amendment was passed at the end of 2016, capping public expenditures for the next 20 years. This came after government debt had hit 70% of GDP in August 2016. In practice, the measure forces different government agencies to spend, at most, what was spent the previous year, adjusted by inflation. Although this may be seen as unnecessary or even damaging –a forced austerity policy that leaves the government with its hands tied to boost economic recovery–, it will help tackle Brazil's main problem today: the ever-heavier burden of public debt. If needed, monetary policy still has a lot of room to boost demand, given that rates are still high, unlike in many advanced economies. Moreover, in a context of high inflation, we believe this measure has more pluses than minuses.

Figure 8

INTEREST RATES ARE STEADILY GOING DOWN

Daily data between 10/1/07 and 7/28/17.

Source: Innealta Capital using data from Bloomberg.



2.2. Labor market and productivity

Unemployment in Brazil is currently at 13% (Q2 2017), which is roughly equivalent to 13.5 million people. This is an improvement over the first quarter (13.7%), but a step back if compared with Q2 2016 (11.3%). The Global Competitiveness Index 2015–2016, a report by the World Economic Forum, ranked Brazil 122nd out of 140 countries in terms of overall labor market efficiency — and 132nd regarding flexibility. This had much to do with the labor statute, stemming from 1943. As for productivity, a Credit Suisse study concluded that it has been stagnated in the period 1981-2016. In particular, the last few years (2011-2016) have had an overall negative productivity growth rate (-1.1%), rolling back the gains of the 1990s and 2000s. Although the causes are debated, low education levels and skill mismatches in the labor market are usually mentioned amongst the problems that will need to be tackled in order to boost productivity.

What has been done recently? This is one of the areas in the economy that has seen substantial and much-needed reform In July, President Temer signed labor reform into law. Resisted by many in the unions (it spawned three general strikes), it will make hiring and firing easier for companies. It has, moreover, put an end to mandatory union dues. Just before the reform was approved, it was estimated that Brazil had over 17,000 unions (compare with neighboring Argentina, which had approximately 100). The new law will make the labor market more flexible–for example, by allowing agreements between employers and employees to supersede the labor code. It also will make part-time work and outsourcing easier, and reduce litigation. Additionally, it should help reduce the number of workers in the informal sector (around 10 million last year).

2.3. Regulations and taxation

Brazilians have creatively dubbed the series of regulations and bureaucratic hurdles that make investment harder in their country as *custo Brasil* (Brazil cost). This hurts growth prospects by making the country more prone to specialize in low value-added products (like commodities), importing those high value-added, technology-intensive goods that would be more costly to produce locally. A 2013 study estimates that, on average, a product would cost 37% more to produce locally than in Germany or the US. This is due to dearer inputs, higher interest rates, and heavier taxes, for the most part. The differences with China, for example, are even greater.

What has been done recently? The government has just introduced legislation that seeks to make taxation more efficient. Although the overall burden (35% of GDP) and its composition — tilted more towards consumption than income — will not significantly change, taxes will be simplified and their payment will be easier. Probably the most conspicuous change proposed is the introduction of a value-added tax (VAT), substituting a series of taxes that are currently levied.

3. On the way to recovery?

Recently, things have started to improve, beyond the reforms discussed in section 2. Inflation is at its lowest level since 1999: it reached 2.71% for the last 12 months in July of this year. Yearly interest rates at the end of July were back to a single digit, unseen since October of 2013. This creates a virtuous cycle, for lower inflation gives the monetary authority more room to cut interest rates, which in turn helps to boost economic activity (see figure 8). Moreover, it seems GDP will grow in 2017 (after the first two quarters showing positive growth). After not seeing quarterly growth during all of 2015 and 2016, this is definitely a very encouraging development. (A survey of financial analysts compiled by the Central Bank shortly before the end of Q2 showed an expected growth rate of 0.34%, while the IMF forecasts 0.3%.)

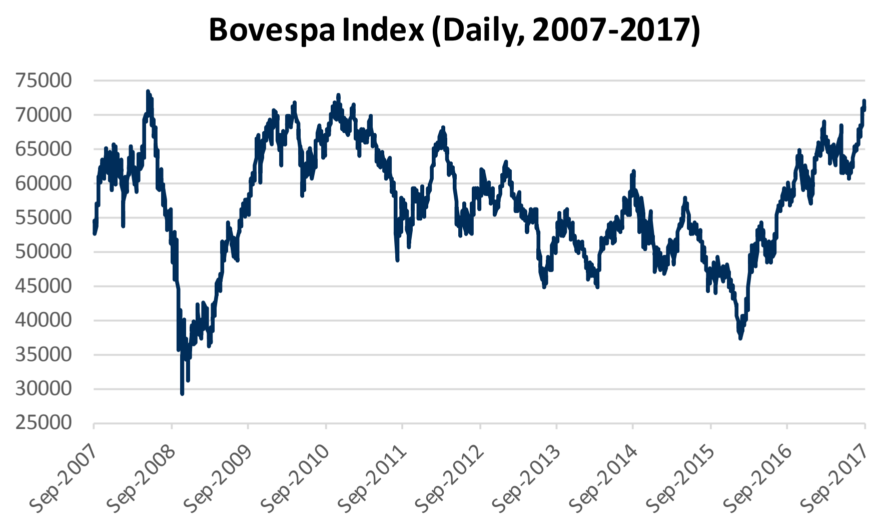
Finally, the government announced at the end of August a $14 billion privatization plan. As part of the plan, infrastructure concessions and oil rights will be auctioned off, and the same will go for airport licenses in numerous cities. Most notoriously, six power distributors owned by Eletrobras¬–the largest power utility company in Latin America, of which the government owns 52%–will also be privatized. This will help the government collect much-needed funds to palliate its current fiscal problems. Plus, it should be a source of efficiency gains. For example, 3G Radar, an investment firm specialized in Brazilian equities and a shareholder at Eletrobras, estimates that the country has lost BRL 228 billion (more than $72 billion, 4% of the nation's GDP) since 2002 just at Eletrobras, only because of poor management and political capture. This plan represents, therefore, a huge opportunity for investors: political and economic risk will be incorporated into prices (effectively lowering them), opening up the possibility of extraordinary returns in the long run.

Figure 9

THE STOCK MARKET IS REFLECTING ECONOMIC RECOVERY

Daily data between 9/5/07 and 9/4/17.

Source: Innealta Capital using data from Bloomberg.



4. Conclusion

Although Brazil is just coming out of its worst recession on record, and many of the problems that have plagued the country for decades are still there, we are confident that the country has left the worst behind. Major labor and government-spending reforms have been passed, while the government has introduced additional ones (e.g., tax reform). The country is in recession no more, with two consecutive quarters of positive growth. The country's main stock index, the Bovespa, has been steadily rising since June, reaching heights unseen since 2010 (see figure 9). The latest corruption scandals seem to have marked a turning point, at least in terms of accountability. This should deter, at least partially, corrupt practices that have been widespread for too long. Commodity prices are recovering, in line with predictions. And, finally, it has become more likely that a market-friendly candidate will prevail in the presidential election of October 2018. For all of these reasons, we are optimistic about Brazil. Our investment team and quantitative analysts are closely monitoring developments within the country, ready to take advantage of the new opportunities that will arise. The volatility we have observed in the last decade, in addition to the commitment we have seen from authorities towards political and economic reform, make us confident that Brazil holds great investment opportunities.

*****