Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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Emerging Markets | Equities | High Conviction Active

Brazilian Economy Boosted by Reasonable Government Legislations and Tight Monetary Policy

By: Paul Psaila | February 5, 2024

KEY POINTS

1. A year into President Lula's term, the political and economic situation in Brazil is better than many had expected.
2. The economy will likely grow more than expected as interest rates continue to fall.
3. We believe Brazil remains cheap compared to other emerging markets with lower inflation and rates acting as a tailwind for growth.

Our recent trip to Brazil confirmed three key observations regarding the potential for investing in Brazilian markets a year into the new leftist administration's term.

A year after President Luiz Inácio Lula da Silva took office in January 2023, Brazil's political and economic situation has proven to be considerably more favorable than most market participants initially had anticipated. After Lula narrowly defeated incumbent Jair Bolsonaro, observers braced themselves for a sharp move to the left accompanied by fiscal recklessness. However, the past year has turned out to be better than expected, mirroring Lula's first term in the early 2000s. The economy has experienced a positive turnaround, Congress passed a long-awaited tax reform bill while the pro-Bolsonaro protesters who stormed the capital on Jan. 8, 2023, were sentenced to jail, similar to the January 6, 2021, United States Capitol attack. Moreover, the government has not pressured publicly listed state-owned companies to undertake populist, non-economically driven measures, which helps to explain why companies, such as Banco do Brazil and Petrobras, were the best performing stocks, up 75% and 50% respectively last year.

Secondly, we believe interest rates will continue to fall, helping the economy to exceed growth expectations. In early 2023, Brazil's gross domestic product (GDP) growth was projected to be below 1% for the year. Despite very tight monetary policy, growth came in at 3% driven by strong performances in the financial, mining and agricultural sectors. Unemployment remains very low, while wages and new job creation are growing. Going forward, growth should be boosted, driven by falling interest rates.

Finally, while Brazil was one of the first among emerging market economies to raise interest rates to curb inflation, the Brazilian Central Bank (BCB) is in a rate cutting mode. Post pandemic, the BCB aggressively hiked the benchmark SELIC rate to a peak of 13.75%, a move that puts Brazil in the gold medal category for raising rates. As inflation plunged from a peak of 12% in 2022 to below 5% in December. the BCB cut the SELIC rate to 11.75%. Still, the country has the highest real rates in our investable universe, and we expect more rate cuts in the future. Lower inflation and interest rates will be a tailwind for growth and should lead to investments flowing out of fixed investment into equities. Notably, the market remains cheap versus its own history and the rest of the emerging markets.

Bottom Line: Brazilian equity markets are known for their volatility, fluctuating from being one of the top performers one year to falling to the bottom ranks the following year. Currently, Brazil benefits from reasonable government legislations and tight monetary policy. Lula wants lower interest rates to spur economic growth but is stymied by a central bank that is urging fiscal discipline. As long as this balance holds, we are constructive on the outlook for Brazil.

RISK CONSIDERATIONS

*There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries.*

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