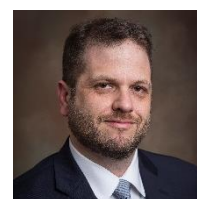




NOTES FROM THE ROAD
TRAVELING THE EMERGING MARKETS
Brazil

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VOTERS OPT FOR SWEEPING CHANGE AND MARKETS APPLAUD



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Jair Bolsonaro's recent victory in the country's presidential election against Workers' Party candidate Fernando Haddad was no surprise, as the former army captain rode a wave of anti-establishment fervor in a country desperate for change. He will assume the presidency on January 1, 2019.

I've visited Brazil many times over the past decade, a period marked by significant economic growth but beset by searing government ineptness, which has led to corruption scandals of two presidents, Luiz Inacio Lula da Silva, who was convicted of money laundering, and Dilma Rousseff, who was impeached and removed from office. Indeed, during my most recent trip, I witnessed just how fed up Brazilians have become with corruption and crime and how much they and investors are hoping for economic progress under Bolsonaro.

KEY TAKEAWAYS

- Bolsonaro's sweeping victory should pave the way in forming alliances to govern and help his government pass reforms through Congress, especially in the first six months of his presidency.
- While Bolsonaro's commitment to economic reform is still unclear, we expect he recognizes the need for market support and will put together a pragmatic economic team under Paulo Guedes, a University of Chicago-trained economist credited with steering Bolsonaro toward market-friendly policies.
- Bolsonaro will need to address pension reform to maintain the backing of financial markets.
- The biggest risk for investors and Brazilian markets is that Bolsonaro opts not to use his political capital to forward pension reform.

A SIX-MONTH HONEYMOON

I believe Bolsonaro will benefit from a six-month period of legislative cooperation during which he will need to form alliances to govern and pass reforms through Congress. His Social Liberal Party (PSL) will hold 52 seats, making it the second-

largest bloc in the Lower House of Congress. This support and his popular backing should enable him to build a coalition with a loyal rural/evangelical base of 200 of the 500 seats in the Lower House. This should strengthen his hand in negotiations with the Centrao, a five-party centrist coalition bloc, whose help he will need to push forward his agenda. I expect markets to do well during this period, especially if he and his team can enact pension and tax reforms.

RESPECTED ECONOMIC TEAM SHOULD REASSURE MARKETS

While Bolsonaro's commitment to economic reform remains unclear, we expect he understands the importance of market backing and will assemble a pragmatic economic team under Paulo Guedes, a University of Chicago-trained banker credited with steering Bolsonaro toward market-friendly policies. Bolsonaro's conversion to economic liberalism seems genuine, and I expect Guedes to build a good, market-oriented team. Guedes, who will become Bolsonaro's finance minister, has reportedly asked Ilan Goldfajn, the highly respected head of the central bank since 2016, to stay. He also called on Mansueto Almeida to remain in place as the Secretary of National Treasury (a key position in the Finance Ministry). Markets have reacted well to Guedes and should reward Brazil for its market-friendly policies.

I expect Guedes will encourage Bolsonaro to begin pension and tax reform early in his term before moving toward his own overly ambitious privatization program. The government is under pressure to address the imbalance in the pension system, which faces inadequate financing to address rapid growth in expenditures, the primary source of the government's growing indebtedness. Investors need to see that Bolsonaro's government is taking reform seriously if they are going to keep their money in Brazilian markets. I believe Guedes will seek reforms similar to those sought by the government it is about to succeed—an increase in the retirement age and a reduction of some benefits, phased in over a number of years to reduce the immediate impact on those close to retirement.

BIG INVESTORS ON BOARD

During my trip to Brazil, I met with local investors, such as institutional investors and large hedge funds. These firms, known as multimarket funds, manage the wealth of Brazil's richest families. Unlike 10 years ago, when foreign investors moved Brazilian market prices, these funds now drive the flows. They have a lot of leverage and have become much more important, especially in fixed income markets. Many of the funds are run by former central bankers and economic officials and most support Bolsonaro, despite their concern about the threat he could pose to democratic values and their personal objection to some of his more reactionary social policies.

Their support for Bolsonaro is mainly driven by their rejection of the Workers' Party in the wake of the 2015–2016 economic and financial crisis, which featured massive increases in public sector lending, sharp reductions in interest rates during a period of accelerating inflation, and growing fiscal deficits.

INVESTMENT OPPORTUNITIES

Before the first round of elections, assets were pricing in the possibility that the left-leaning candidate would gain more of the vote. Everything in Brazil looked cheap, as markets were concerned about a potential return to the unsustainable policies of the Rousseff years. Now valuations have mostly normalized. There may be a bit of room for spreads on Brazilian government debt to tighten if pension reforms appear promising. Brazil's fundamentals are actually solid, in my view. The current account deficit remains quite low by historical standards. The rate of inflation is moderate, albeit rising. However, growth has remained weak, as the recovery from the 2015–2016 recession has been slow. Bolsonaro's policies could support a rebound in investment, which remains about 25% below (in real terms) its prior cyclical high in 2013. Market gains and the country's economic prospects depend on pension reforms. If debt levels stabilize, I think money—domestic and foreign—should flow into Brazilian assets.

THE RISKS

I will be watching to see if Bolsonaro can maintain his coalition with the Centrao, which would be a purely transactional relationship. If and when his popularity fades, the Centrao would want to be repaid in some way for

every vote of support. Traditionally, this is done by appointing coalition allies to key public sector positions and through earmarks that support public investments in politicians' local districts. Negotiating a quid pro quo for every vote will slow the pace of reform, in my view, and markets could respond by punishing Brazilian assets.

The biggest risk for financial markets and investors is Bolsonaro's commitment to economic and pension reforms. He has vowed to crack down on crime and corruption, and we are unsure if he will ultimately be willing to expend his political capital for economic victories. The market needs to know that reform is in the works and that Brazil's public sector debt will not grow unchecked forever.

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