Brazil:

LOOKING BEYOND THE CURRENT MALAISE

EXECUTIVE SUMMARY

- Brazil has experienced its worst recession in a century, but we now see signs that parts of the economy are bottoming. However, a recovery won’t emerge until tough reforms are implemented.

- Investors are encouraged by the likelihood of a regime change, but the way forward will be fraught with challenges and uncertainty.

- We believe Brazil offers attractive longer-term investment opportunities.

- In our view, many stocks are trading at attractive valuations, and we have built a slight overweight exposure to the country within our emerging markets portfolios. Stronger companies, particularly among private banks and consumer names, should do well once the economy regains its footing.

Brazil offers attractive investment opportunities for those willing to look beyond the current uncertainty and focus on high-quality companies with strong managements and attractive growth prospects.

The case for investing in Brazil has not been an easy one to make over the last few years. The country is grappling with its worst recession in over a century as it battles the impact of weaker global demand for its commodities and the repercussions from the fiscal policies that embattled President Dilma Rousseff and her Workers’ Party (PT) implemented over the past five years. The combination of weaker tax revenues and higher expenditures on social programs eliminated Brazil’s fiscal buffers and created a deficit that ballooned to 10% of the economy.

Adding fuel to the fire is an ongoing corruption scandal that could force Rousseff’s removal from office over allegations that she used funds from state banks to conceal budget shortfalls. A separate inquiry into the state-owned oil company Petrobras, involving alleged bribery has ensnared Rousseff’s Workers’ Party. In the face of the poor economy and the scandals, Rousseff’s popularity has fallen into the single digits,
and protesters across the country are calling for her impeachment. Businesses have stopped investing in capital projects, and consumers have slowed their spending as they wait for more clarity on which way the political winds will blow.

Despite the general malaise, investors are beginning to consider the prospects for Brazil if Rousseff is removed from office and a more fiscally prudent regime takes over. The Bovespa stock index, which fell more than 41% in U.S. dollar terms in 2015, has gained steam amid the emerging view that the worst may be over—or at least has been priced into the market. Indeed, for the first time since this crisis began, there are some encouraging signs. Inflation, while still high, appears to be easing, and the weak real has helped the current account.

However, we believe that long-lasting economic stability will only occur once structural reforms are implemented, particularly in the area of fiscal policy. These reforms include changing or modifying social programs that have grown to be unaffordable, in part, because they are too generous and, in part, because they are legally protected and require a constitutional amendment to cut, which is only possible under a regime change.

Until then, investors should focus on identifying the sectors that will benefit most from the fundamental trends that we believe will drive Brazil’s growth over the long term, homing in on the highest-quality and best-positioned firms within those sectors. In our view, some of the best opportunities currently exist in select financial institutions and consumer-driven companies.

TROUBLED TIMES

Over the past five years, the Rousseff administration has cut taxes and increased spending, pushing the government’s fiscal balance into a deficit and undermining what had previously been one of the emerging markets’ most championed economic success stories. Most recently, congress preserved a popular social welfare program by reducing the government’s fiscal savings target via vital cuts to capital expenditures. These actions, along with the dramatic fall in commodity prices and the corruption scandal surrounding Petrobras, have severely hampered the country’s economy, which contracted 3.8% in 2015. Analysts estimate that it will shrink another 3.0% this year and do not expect to see growth in 2017. Thanks to these myriad pressures, Brazil’s economy is smaller today than it was in 2012.

These challenges have weighed on Brazil’s currency. The depreciation of the real in 2015 was notably worse than declines seen in most other emerging market currencies. The ensuing rise in inflation and interest rates has further depressed consumer and business confidence and put yet more pressure on Brazil’s fiscal position. Rousseff’s handling of the economy has caused division among the Brazilian people, who have become increasingly polarized, with mass demonstrations becoming more frequent.

Figure 1: Emerging Markets—Calendar Year 2015 Exchange Rates

As of April 13, 2016

Source: FactSet
A LONG ROAD TO RECOVERY

Brazil’s path to recovery will not be easy. First, it needs to close its current budget deficit by reforming its social programs, most urgently social security. Around 50% of Brazil’s public expenditures go to support those in the lower and middle income categories. This spending is part of the PT party’s so-called social contract, which is written into the country’s constitution and is governed by rigid mechanisms that make changes and adjustments very difficult. The overhaul of this system will be very difficult to enact since it requires a constitutional amendment. None of this is likely to happen while the PT party remains in power.

Private consumption, which accounts for about 60% of Brazil’s gross domestic product (GDP), has decreased as a percentage of GDP over recent quarters, with household spending being particularly weak. The decline in labor market participation and the decrease in real wages contributed to the fall. In order to restore consumer spending, the labor market must strengthen, which may require changes to employment laws that make it difficult and costly for companies to adjust their workforce.

Finally, exports compose only about 13% of GDP, and tariffs restrict trade flows into the country. Simply put, Brazil needs to open its economy to more trade and broaden its trading partners. Reform should also focus on lowering the cost of doing business, which in turn, will help drive the international competitiveness of some of Brazil’s bigger export companies. Fortunately, the weaker real should be supportive of Brazil’s exports.

We don’t believe that deep reform is possible amid the current political turmoil. If Rousseff remains in office, her low approval rating and weakness within her own party will make it difficult for her to win the votes necessary to pass needed spending cuts—never mind constitutional changes. The two-year-old Petrobras investigation, one of the biggest corruption scandals in Brazil’s history, has implicated many of Brazil’s politicians and businessmen, including former President Luiz Inácio Lula da Silva, the PT party, and even the more centrist Brazilian Democratic Movement Party. The scandal has led to further political paralysis and delayed any prospects for making meaningful fiscal reforms.

INVESTORS SHOULDN’T IGNORE BRAZIL

Clearly, Brazil has some significant economic and structural challenges to tackle. However, investors need to remember the positive developments that have occurred over the last 15 years, making the country an important consideration for those seeking emerging markets exposure. Despite recent government missteps, Brazil has implemented strong corporate governance regulations, and its stock market is much larger and more liquid than any other in Latin America. Moreover, with a massive middle class and 60% of the population below 30 years old, consumption-driven areas of the economy should continue to benefit, particularly as household formation grows.

While the weaker real hampered purchasing power in 2015, it helped Brazil’s export sector recover somewhat in the fourth quarter. This, combined with the steep decline in demand for imports, allowed its trade balance to improve. Foreign direct investment is increasing, excess capacity is coming out of the system, and nonperforming loans are being recognized and reserved for by the banks. Brazil has significantly increased its foreign currency reserves and has a more flexible currency regime than it did a decade ago. Finally, if there is a silver lining in the Petrobras investigation, it is that it highlights the strength and independence of the country’s judiciary system.

While 2016 will be challenging, strong companies with balance sheets that can sustain through the stress should emerge much leaner and offer strong appreciation potential in the medium and long term. Some of the defensive consumer stocks have continued to deliver strong results throughout the crisis, for example. These management teams are now focused on strengthening their balance sheets, paying down debt, cutting costs, and improving their competitive position in anticipation of the period when the economy improves. Valuations for many of these stocks are discounting the current weak environment but are not factoring in the prospects for improvement beyond the current malaise, in our opinion.
As was the case in Argentina last year, markets can rally well before hard evidence of economic improvements or changes in government policies. While it is difficult to time such a shift in investor behavior, we believe that most of the bad news in Brazil is well known. This year’s rally in the real and in Brazil’s stock markets seems to provide some evidence that investor sentiment has begun to turn.

**Figure 2:** Brazil’s Valuations: Brazil’s Premium (Discount) to Emerging Markets for the Last 10 Years

As of February 5, 2016

Sources: Citi and MSCI

**T. ROWE PRICE’S CURRENT POSITIONING**

We have used the downturn over the past year to build a slight overweight exposure to Brazil within our emerging market and Latin America equity portfolios. Although valuations are not as attractive as they were at the beginning of the year, we still believe many stocks are trading at favorable levels that are not fully discounting an improved outlook for earnings over the next two to three years. Our focus is on quality companies that have a strong runway for growth, healthy balance sheets, and a strong competitive position. We have avoided most stocks in the materials and energy sectors because of their weak balance sheets and our more cautious view on commodity prices.

Financial stocks compose our biggest sector overweight, with a particular focus on select private sector banks that are well capitalized and should be able to gain market share. The financials sector has been a notably weak performer because of investor concerns over nonperforming loans and asset quality. However, Brazil’s higher-quality banks have historically held up well when faced with economic downturns, proving an ability to anticipate and adapt by enacting pragmatic and forward-looking measures to protect profits. The current crisis has been no exception. Our investments are with firms that have been able to weather the storm by maintaining conservative lending policies and proactively building ample reserves against their expected loan loss provisions. These banks should benefit once credit conditions bottom and begin to improve.

Consumer-oriented businesses make up our other overweight sector positions, with retail stocks offering some attractively valued opportunities. The retail sector has been under pressure from the significant decline in household expenditures. However, the country’s growing middle class and relatively young demographic bodes well for consumption-driven areas of the economy over the longer run. Stronger companies should be able to gain further market share in the still-fragmented retail industry. An additional opportunity is the growing trend toward online shopping, given that e-commerce currently represents just 2.5% of Brazilian retail activity.
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