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Brazil at a crossroads: aiming higher

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Key take aways

- Future economic growth hinges on further structural reform.
- The Banco Central do Brasil (BCB) has been able to cut interest rates and is likely to keep monetary policy accommodative.
- Social security reform and the prospect of sounder public finances bode well for Brazilian equities.

01 Economic revival supported by structural reforms

Having gone through a deep recession in 2015/2016, during which GDP contracted by nearly 7%, the recovery of the Brazilian economy has been disappointingly slow. In 2017 and 2018 real GDP growth failed to rise above 1.1% per year. Political uncertainty at the start of this year has dented business confidence to the point where we expect GDP growth to slow even further in 2019, to 0.8%, dragged down by a slump in Q1. The Purchasing Manager Index (PMI) for the manufacturing sector has turned negative in July, dropping to 49.9, the first negative value this year, which goes to show that Brazil is not immune from the global weakness in manufacturing. However, there is light at the end of the tunnel. The economy may be about to bottom out: after having contracted by 0.2% QoQ in Q1, GDP growth bounced back in Q2 to +0.4% QoQ and +1.0% YoY. Business sentiment has turned a corner as well, not least because political uncertainty has receded. Some major social security reforms have been tackled and the fiscal outlook is improving, paving the way for growth-oriented policies. Indeed, it is thanks to progress on the social security front that the central bank has been able to cut interest rates on July 31.

Similarly to many other countries, the services sector is holding up rather better than manufacturing, as evidenced by the Services PMI index that improved significantly in July to 52.2 from 48.2 in June. Industrial confidence is improving for large and small companies alike, especially for domestically oriented small and medium-sized companies. As a result, next year we expect economic growth to accelerate to 2.0%. Despite these cyclical tailwinds, there is much work still to be done. Brazil needs to tackle tax reform and privatization, on top of opening up trade and financial intermediation in order to boost growth. Given high levels of public debt, this would have to be achieved while maintaining a broadly neutral fiscal stance, an accommodative monetary policy and a flexible exchange rate.

02 Progress on social securities reform not sufficient

Due to the high level of debt and the need for fiscal consolidation, next year the Brazilian government plans to embark on an expenditure-based fiscal consolidation program anchored by a constitutional expenditure ceiling. The key points imply a reduction of government expenditure by about 0.5% of GDP per year for the next eight years. In this case, gross public debt would peak at about 96% of GDP in 2024. The expenditure ceiling will represent a strong anchor for fiscal discipline and boost investor confidence. In a slow growth environment with expectations for lower tax revenues, it is important that non-recurring revenues are used to reduce primary deficits and public debt. The government has scheduled a large auction of oil reserves for October. Apart from such an oil revenue windfall, privatization proceeds could also be used to reduce public debt. The federal government's direct investments in state-owned enterprises amount to nearly 5% of GDP. Although half of these are considered strategic (e.g. oil companies, utilities, public banks), and thus unlikely to be sold, there seems potential to divest subsidiaries and other companies.

The most important reform, however, concerns social security. The average retirement age in Brazil is 54 years, compared to an OECD average of 64, on 70% of the last salary (vs. 53% in the OECD), not counting special arrangements for civil servants and armed forces. This generous system has created an imbalance of pension payments vs. contributions, to the detriment of government finances. High nominal public deficits of close to 7% of GDP caused a spike in the public sector debt ratio from 60% of GDP in 2013 to more than 90% in 2019 (IMF Fiscal Monitor, April 2019). Social security spending made up for half of total public spending.

In order to put the system on a sustainable footing, wide-ranging reform had become inevitable. Despite a comparatively fragmented parliament, the new government was able to find a majority for such a reform, albeit a slightly less ambitious one than originally planned, as the originally planned savings over 10 years of BRL 1.2 trillion were cut down to about BRL 880 bn. This reform made faster progress than expected and was approved in the Lower House on July 17. However, thanks to these savings, pension expenditure as a share of GDP has merely been contained, not reduced.

03 Bullish signals from the central bank

The Banco Central do Brasil (BCB) decided to reduce its key interest rate, the Selic, by 50 bps to 6% on July 31. This cut was twice as big as consensus expectations and was made possible by the favorable domestic developments just described, helped further by accommodative monetary policy in most other countries. Even though it can't be ruled out that the pension reform will be watered down again until the final reform act is passed, the Banco Central do Brasil is expected to implement two further rate cuts this year. Inflation is under control, in fact it has fallen below BCB's target of 4.25% for this year and of 4.00% for next year. Although the BCB has highlighted a data-dependent re-evaluation of its monetary policy stance, the favourable inflation outlook is fuelling market expectations for rate cuts towards 5% - 5.25% by the end of the year.

04 The three stages of the Brazilian bull market

As shown in Chart 1, since October 2018, when the current government was elected, Brazilian equities are in a bull market, as the MSCI Brazil is vastly outperforming (in USD) both the broader MSCI LatAm (+18.0%) and the MSCI EM (+22.7%). This upswing can be divided into three stages. The first stage, from October 2018 to January 2019, was mainly driven by expectations of fiscal consolidation and by the Brazilian president's promise to fight corruption, implement crucial reforms and simplify the tax code. The second stage saw the fulfillment of these expectations as the social security reform was pushed through the Lower House Justice and Special committees. We believe that the ongoing third stage will culminate in the Lower House floor vote on social security reform in Q3. So far, investors remain optimistic that this reform will be completed, causing a 5.0% appreciation of the MSCI Brazil (in USD) from its mid-May low that compares favorably with the MSCI Latam's -1.6% over the same period and the MSCI EM's -3.2%.

05 Beyond social security reform

Tax reform is expected to move forward as well, along with other minor projects (e.g. the water & sewage bill, transfer of oil rights, privatizations, etc.) – all likely to boost the equity market. Another stimulus is due to come from the release of FGTS accounts (Fundo de Garantia do Tempo de Serviço, a worker guarantee fund). Brazil's economy ministry reckons that allowing employees to access cash from this FGTS fund could add 0.35% to GDP over the next 12 months. We believe that the social security reform will be accompanied by lower interest rates and other stimulus measures that are likely to lead to greater inflows into Brazilian equities, especially on domestic cyclical sectors.

06 Brazil´s re-rating

The MSCI Brazil is currently trading at 12.7x NTM earnings – 0.3 standard deviations above its 10-year NTM P/E ratio of 12.2x (see Chart 2), which we consider ambitious in this context of falling earnings growth. Except Materials, Energy and IT, all sectors are trading at a remarkable premium to their own long-term historical average, led by Industrials (+74.4%) and Consumer Discretionary (+59.1%). Brazilian fundamentals are showing signs of recovery: the economic activity index (+0.30% MoM) testifies to an expanding economy for a second consecutive month after having contracted in February and May. Sovereign rating upgrades are on the horizon as well, but it is corporate earnings growth that will determine whether a re-rating of the Brazilian equity market is called for.

Investors are interested in Brazilian equities at more expensive valuations as long as economic growth is strong. Consensus forecasts suggest an earnings growth rate for the MSCI Brazil of 8.8% in FY 2019 and 14.1% in FY 2020. Although MSCI Brazil FY 2019 aggregate earnings have been revised down by 17.2% since the beginning of the year, depressed by IT and Energy (both -38.3%) as well as Industrials (-35.5%), we may be about to see the back of negative earnings revisions. We like the idea that the investment case for Brazilian equities in the medium-term is becoming less dependent on politics, and more dependent on economic growth prospects.

07 Unresolved issues

On the other hand, there remain unresolved issues, some of which are structural. Youth unemployment is high and has increased steadily over the past few years, climbing from 13.6% in 2013 to 24.6% in 2016. Overall unemployment is rising as well. At the bottom of this development lie deficiencies in primary and secondary education that hold back the potential of the country's economic development. Another weak point is widely considered to be corruption, which translates into low confidence of the population in the rule of law. On the corruption perception index calculated by Transparency International, Brazil has fallen from 43 out of 100 points in 2014 to 35 in 2018, a worrying trend. In terms of security, the government has repeatedly carried out crackdowns on drug-trafficking militias, but the underlying problem has not been solved. On another level, while the country is rich in natural resources, some of these, such as the abundant forests, are for the most part not sustainably managed, reducing their value.

08 Overweight backed by structural change growth story

The progress with structural reforms is the reason why we tend to overweight Brazilian equities within the region. We see room for the Brazilian economy to grow and corporate earnings to improve once all outstanding measures gain traction.

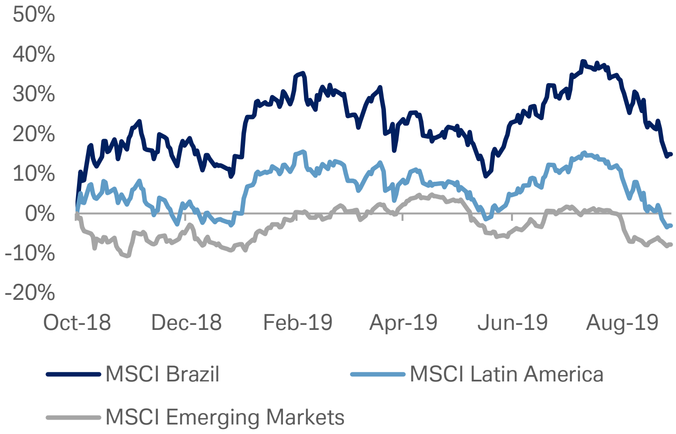
We believe that the final approval of the social security reform in Q3, coupled with the proposed spending cap legislation, could underpin a structural bull market in Brazilian equities over the next few years as these measures limit the risk of fiscal profligacy and thus help the country's fiscal consolidation by tying Brazil's debt to GDP growth. At the same time, Brazil seems to be somewhat isolated from global trade woes, which represents an additional argument for foreign investors to increase allocations to this country.

However, in Q4 of this year we expect an expansion in earnings multiples to remain the key driver of Brazilian equities and emphasize that Brazil might enter a period where multiples will be consistently above average, "the new normal", as it was the case with Chile in the past. Should the Brazilian economy – contrary to our expectations – fail to accelerate soon, the bull market could then easily run out of steam. From a longer-term perspective, it is clear that macroeconomic stability is crucial for economic and asset price growth. Lastly, we expect that any reform progress in Brazil will strengthen the BRL. Historically, Brazilian equity markets have exhibited statistically significant negative sensitivity to the USD.

Technology, Telecom & Media, Retail and Transportation should benefit from a stronger BRL as these sectors have a strong exposure to domestic companies with a significant share of their costs, capex and debt being denominated in foreign currency. To the contrary, Pulp & Paper, Mining, Agriculture and Steel are considered to benefit the most from a weaker BRL as these sectors largely comprise commodity producing companies that sell their products internationally, thus generating a bulk of their revenues in USD.

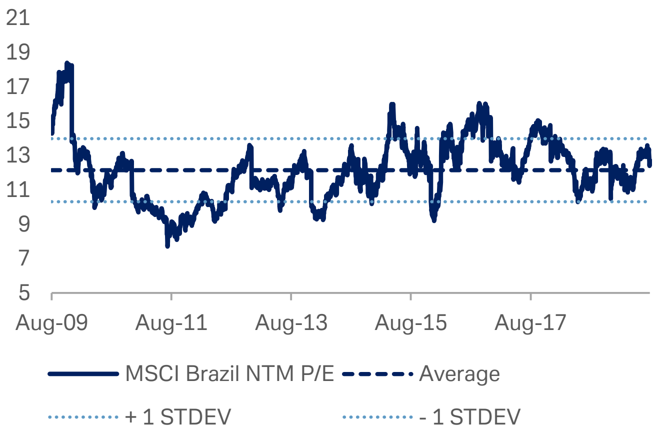
Referring to our overarching investment theme "take profits and recalibrate", investors could consider allocating funds from equity investments with a broad emerging market or LatAm exposure to those with a more Brazil specific exposure to benefit from a growth story which is particularly driven by promising longer term reforms and structural changes.

Chart 1: Performance MSCI Brazil



Source: Bloomberg, Deutsche Bank AG.
Data as of August 28, 2019.

Chart 2: MSCI Brazil NTM P/E ratio



Source: Bloomberg, Deutsche Bank AG.
Data as of August 28, 2019.

Glossary

The Banco do Brasil is Brazil's central bank.

BPS stands for basis points, equivalent to 1/100 of 1%.

BRL stands for Brazilian real, Brazil's official currency.

GDP stands for Gross Domestic Product, i.e. the value of all goods and services produced in a country in a given period of time.

MSCI Brazil is an equity index of the Brazilian stock market. It is designed to measure the performance of the large and mid cap segments of the Brazilian market constituents. It covers about 85% of the Brazilian equity universe.

MSCI EM is an equity index that captures large and mid cap stocks across 26 Emerging Markets (EM) countries. With 1,193 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI LatAm (Latin America) is an equity index that captures large and mid cap stocks across 6 Emerging Markets (EM) countries in Latin America. With 118 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
The National Congress of Brazil is bicameral, with a lower house (the Chamber of Deputies) and an upper house (the Senate).

NTM stands for next twelve months.

The Organisation for Economic Co-operation and Development (OECD) has 35 member countries and has the objective of encouraging economic progress and world trade.

P/E ratio stands for price/equity ratio, i.e. the relationship between the price of a stock and the projected earnings per share of the underlying company.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

A recession is usually defined as two consecutive quarters of GDP contraction.

USD stands for US dollar, the official currency of the United States.

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