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Brazil: Pillars Supporting a Re-rating

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Where are we coming from?

The left-wing Workers' Party (PT) governed Brazil for 13 consecutive years, from January 2003 to August 2016. The PT came into power with Luiz Inácio Lula da Silva (Lula) in 2003. During his presidency, Brazil's economy, counterintuitively, prospered, fueled by rising commodities demand from China. Lula took advantage of the prosperity to please his voter base via wealth re-distribution — subsidies, tax breaks to labor intensive industries, and other costly programs — aimed at lifting Brazilians into the middle class. By the time Dilma Rousseff became president in 2011, demand for commodities had declined but Brazil was still borrowing and spending at elevated levels. By 2016, the country's fiscal deficit had grown close to 10% of GDP and the country was facing multiple years of economic contraction. On August 31, 2016, Ms. Rousseff was impeached and removed from office for manipulating the budget. Hours later, acting president and former vice president, Michel Temer of the Brazilian Democratic Movement Party, was sworn in as the new president of Brazil and served through last year's elections. In the fall of 2018, Jair Bolsonaro was elected President and has opened the doors for significant market-friendly economic reforms.

What should drive a re-rating in Brazil?

President Bolsonaro and Economy Minister Paulo Guedes are working on reforms so that Brazil can reach its economic potential.

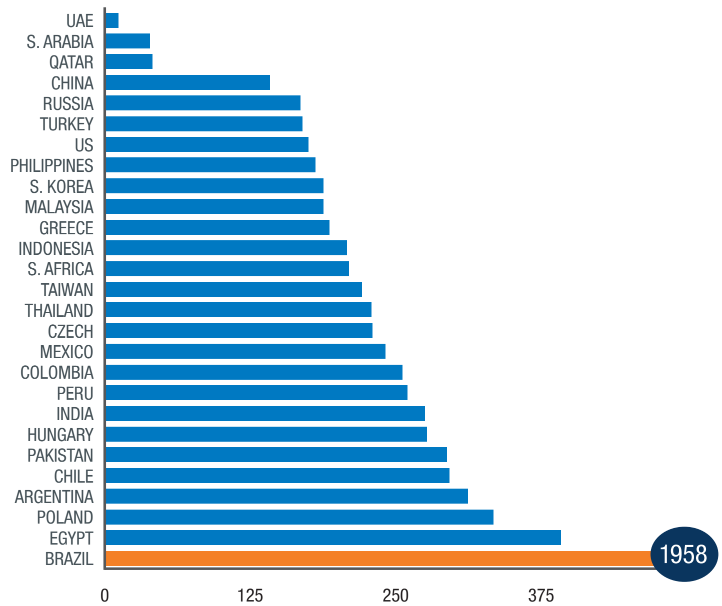
Pension Reform: On July 10th, the lower house showed strong support in approving the main text of the government's pension reform proposal. In early August, representatives approved the second round without alteration. This text approves the saving of BRL 933 billion over 10 years, which is approximately 30% above the market's initial estimates.[1] The bill now lies in the hands of the Senate, and could be approved in the fall of 2019. Pension reform is vital for public sector debt sustainability.[2] This improves credibility, opens financing, and brings investment back into the country. In the process, foreign direct investment should strengthen the currency, lower inflation, and allow the central bank to continue cutting interest rates, and spur growth.

Tax Reform: Brazil's tax system is incredibly complex and expensive. According to the World Bank, Brazil's tax system ranks 184 out of 190 countries surveyed. It takes more time for a mid-sized company to file taxes in Brazil than in any other emerging market country. Economy Minister Guedes aims to simplify the system by using a uniform VAT rate to replace other taxes. He has also proposed to lower the corporate tax rate from 34% to 15%, which should drive positive earnings revisions. Additionally, he plans to hike the tax on dividends from 0% to 20%, which may lead to more re-investment and capex-led growth.

Privatizations: Brazil has the largest number of state-owned enterprises of any country in Latin America.[3] Historically, the market has perceived these companies as inefficient, inflated, and as an impediment for open markets. The new government plans to change this and has even created a role for a secretary of privatizations. The government plans to sell at least BRL 75 billion in assets of state owned companies this year. Not only will this likely improve market efficiency, but it should also increase market liquidity, improve corporate governance, and help adjust Brazil's fiscal balance.

Trade Liberalization: Brazil has a long history of running an Import Substitution Industrialization (ISI) based economy. Essentially, the government has historically implemented high tariffs in order to boost its domestic industries. The current government is taking a new approach to the economy and now intends to focus on free-trade agreements with Latin America, Europe, and the United States.

Time Taken to Pay Taxes (hours per year)



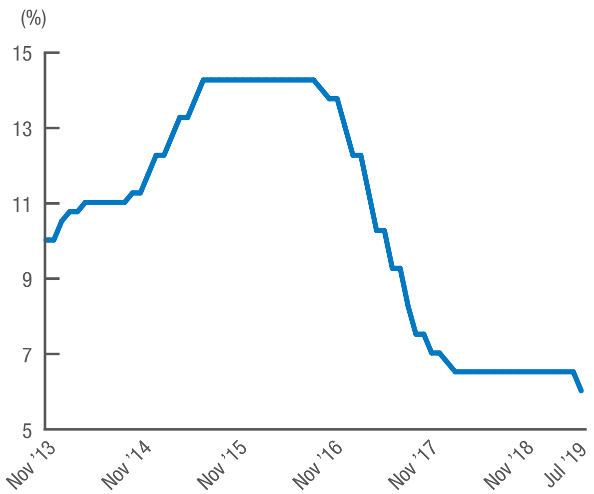
Note: Time taken to prepare, file and pay three types of taxes (Corporate income tax, value added or sales tax and labor tax.) Source: Doing Business 2019 – Training for Reform report, HSBC Global Research.

[1]XP Investimentos, August 2019.
[2]HSBC Global Research, July 2019.
[3]OECD, based on the most recent dataset available (2015), and HSBC Global Research.

Interest Rates

In a world of low interest rates, fixed income and FX investors have looked favorably on Brazil as a country offering attractive yields, but also implementing fiscal, economic, and political reform. With that said, foreign capital has come into the country, supported the currency, and brought down inflation (also helped by many years of low growth). Now, with inflation under control, the central bank has taken on an aggressive rate cutting cycle and has cut interest rates by 825 basis points since November 2016. With most companies levered with floating rate debt, the reduction in interest rates translates directly into lower interest expenses and positive earnings revisions. Additionally, lower interest rates make the bond market less attractive and helps drive capital flows into Brazilian equities.

Brazil is Aggressively Cutting Rates



Source: Bloomberg, as of 8/6/19.

Pent-up Demand

With negative to minimal growth over the past five years, Brazil still operates with roughly 12% unemployment and low capacity utilization rates. As growth and demand return, the market should see quick and significant margin expansion.

The structural story: Occupying 40% of South America's territory, Brazil is the largest country in Latin America and the 5th largest country in the world. In terms of demographics, the country has a strong dependency ratio (more people working than not working), which should provide an important stimulus to the economy for years to come. The country is also rich in natural resources (oil, iron ore, protein, soy, corn, etc). As Guedes said in a talk at the Brookings Institution, "It doesn't make sense to be the 8th largest economy in the world and (ranked) 120-something in terms of ease of doing business. In 4 years we have to be one of the 50 best places in the world to do business."

We remain overweight in Brazil.

In addition to the above, we see the country coming from a low earnings base. Valuations remain attractive and we see key catalysts for a near term country re-rating.

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