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Rate Cuts Required to Remain Optimistic

By David Austerweil, Deputy Portfolio Manager

Deputy Portfolio Manager David Austerweil visited Brazil from November 16 - 18 and met with local asset managers and treasury and central bank officials.

- Brazilian growth is likely to disappoint expectations of 1% next year, with some chance of a prolonged recession and renewed stress on heavily indebted corporate balance sheets.

- Inflation expectations are well anchored near the central bank's target of 4.5% in 2018 and actual inflation could even decline below the target. By not cutting rates rapidly, the central bank will be committing a policy error by keeping real interest rates excessively high.

- There is significant value in Brazilian 5-year interest rates at 12%. The catalyst for 5-year rates to price in the full rate cutting cycle of around 400 bps will likely come when the central bank signals a shift in focus toward growth. Until that time, rates are expected be volatile due to crowded local positions and a challenging external environment.

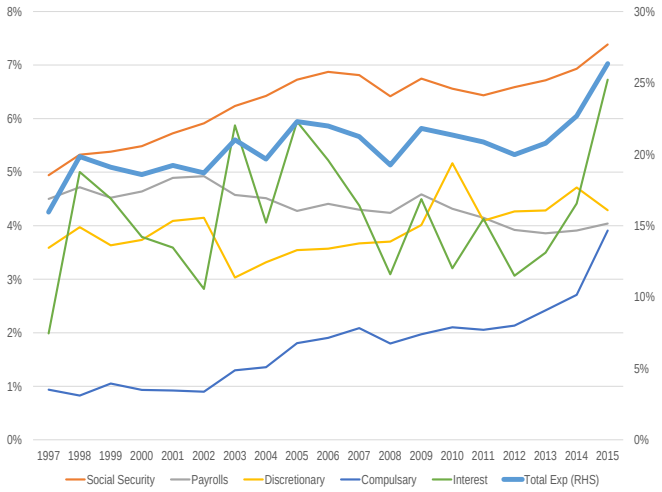
The Fiscal Problem

In 2017, Brazil plans to run a fiscal deficit, excluding interest expenditures, of 2.1%, and of 10.1% with interest expenditures included. With general government debt at the end of 2016 standing at 72.5% of GDP, and without any changes to its fiscal stance, the current trajectory of public debt is unsustainable.

Most local economists estimate that Brazil's potential real GDP growth is between 2% and 2.5% per annum. The local bond market has long-term real yields around 6%. Considering these factors, Brazil would need to run a primary surplus of 2.5% to 2.8% just to stabilize its public debt. This would imply a necessary adjustment of over 4.5% of GDP. This is a substantial fiscal contraction.

The good news is that everyone in Brazil is aware of this problem. Since this includes both houses of congress, there is a clear plan of action to help correct the issue. However, because of the political costs, the underlying drivers of the deficit make the adjustment process particularly difficult. The chart below shows government expenditures as a percentage of GDP from 1997 to 2015. Over that time period, there was not any meaningful growth in discretionary expenditures and many line items were cut dramatically by Brazil's former Finance Minister Joaquim Levy in 2015; there is now virtually no room to cut discretionary expenditures further. However, social security, subsidies, and interest expenditures have grown steadily and their growth has accelerated in the past few years. In addition, because of the demographic outlook and the very early retirement age in Brazil, social security is expected grow from its current level of 8.3% of GDP to 17% of GDP in 2036, if no changes to benefits are made. Fortunately, subsidies are already declining as the Brazilian Development Bank (Banco Nacional de Desenvolvimento Econômico e Social [BNDES]) decreases subsidized lending. However, without an economic recovery, unemployment benefits will likely remain high.

Brazil Goverment Expeditures as a % of GDP

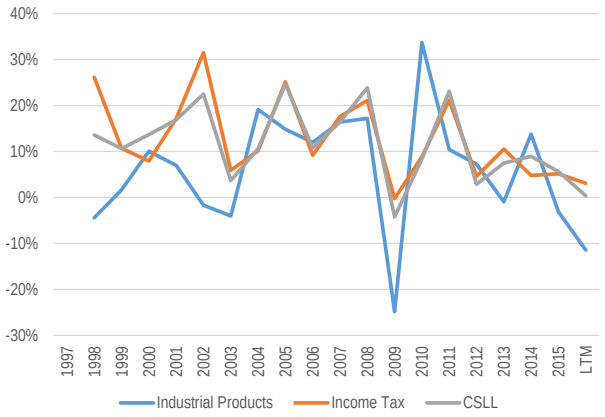


Left and right axis measure as % of GDP; right hand side (RHS) applies to total expenditures as seen in the bold blue line.

Source: National Treasury of Brazil. Charts are for illustrative purposes only. Past performance is not indicative of future results.

Due to the deep recession, revenue collection has not helped the fiscal problem either. The chart below illustrates that three growth sensitive taxes composing over one third of federal revenues are all contracting in real terms, with the industrial products tax also contracting in nominal terms. If the economy does not recover, revenue collection will continue to disappoint.

Federal Tax Issues Revenues
% of Year-Over-Year Growth



LTM = last twelve months

Source: National Treasury of Brazil.

Charts are for illustrative purposes only. Past performance is not indicative of future results.

Economic Outlook and Rates

During my trip, economists from both the private and public sectors were in the process of lowering growth expectations for 2017 from around 2% to 1%, or even lower. The most pessimistic forecasts had the economy falling back into a double-dip recession if the central bank fails to cut rates aggressively enough. With 2017 inflation expectations near 5% and the Brazilian Central Bank's overnight rate (Sistema Especial de Liquidação e Custodia [SELIC]) at 13.75%, the real rate of 9% is incredibly restrictive for an economy trying to recover from a deep recession. A large portion of the corporate sector is having difficulty servicing its debt and it would take a SELIC rate of 10% or lower to allow corporates to roll debt over at affordable levels and rekindle demand for new loans.

There are no obvious engines of growth for next year: exports are dependent on China, government expenditure is contracting, and costly government borrowing is crowding out private sector investment. The government is still working on new terms for foreign investment in infrastructure, meaning foreign participation could disappoint. Consumption is expected to remain constrained by a high unemployment rate and a lack of real income growth. Finally, many states are insolvent, with Rio de Janeiro delaying the payment of wages it owes due to lack of revenues.

We believe the economy is in need of much lower real rates to restore business confidence, solvency and to spur investment and demand for credit. The market is currently pricing 275 bps of rate cuts through year-end 2017. If the central bank were to shift part of its focus from inflation to growth by cutting 50 bps or more at the next meeting and reassessing its growth outlook, there would be room for the market to price another 125 bps of rate cuts for 2017. An added benefit of a large rate cutting cycle would be a significant decrease in the interest expenditures which make up a large portion of the headline fiscal deficit, thereby directly improving the fiscal outlook.

The Temer Government's Plan

The government, under President Michel Temer, has a well-articulated plan for fiscal reform and the political majority to implement it quickly. The two critical reforms are a cap on expenditures of no more than the rate of inflation and a social security reform that transitions to a much higher minimum retirement age. The government has ruled out tax increases as a tool to close the deficit, including bringing back CPMF (Contribuição Provisória sobre Movimentação Financeira), the tax on financial transactions. We believe the resultant pace of fiscal consolidation, however, will likely be quite slow, with primary balance restored only by 2019 and gross government debt to GDP peaking around 80%. Without any government reforms, the growth in gross government debt would be explosive.

How to Invest? What Could Go Wrong?

Receiving interest rates in the front end of the curve (1 to 5 years) still provides value, but the positioning is crowded; longer rates have the added risk of pressure from higher U.S. rates and/or fiscal reform disappointments that lead to a steeper local curve.

Every fund in Sao Paolo told the same constructive narrative on fiscal reform and rate cuts, indicating there was room for disappointment if the central bank only cuts 25 bps in the near term. For this reason, along with the deterioration in the external environment for emerging markets post the U.S. election of Donald Trump, waiting to build long positions until the central bank moves to more aggressive rate cuts makes sense. Given Brazil's strong external position with large levels of foreign reserves and a small current account deficit more than completely financed by foreign direct investment, 5 year and shorter maturity sovereign and quasi-sovereign (Petrobras, Electrobras) bonds still offer value.

There are still a number of significant risks that are currently underappreciated by the market. The Odebrecht plea bargain has the potential to shock the political class of Brazil in March of next year or earlier. While it is likely to kill whatever support remains in society for the PT ("workers") party, it could also disrupt the Temer government's coalition if a large number of congressmen are charged. The central bank could also commit a policy error by cutting rates too slowly in the face of extremely high real interest rates and a tenuous economic recovery. In order to secure popular support, the government could water down the social security reform by having a longer transition time to the new rules. While the states of Rio Grande do Sul, Rio de Janeiro, and Minas Gerais are insolvent, and other states are also in a difficult fiscal position, the federal government cannot afford to bail them out. This means social unrest could rise as workers cease to be paid on a timely basis and services are cut.

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