

Brazilian elections: The calm before the storm?

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EXECUTIVE SUMMARY

- **Unlike in previous elections, there are few signs of politically driven stress on Brazilian markets. Yet, Brazilian markets are in for a reality check in 2023.** The results of the first round of the Presidential elections have reduced the likelihood of extreme policies: markets are familiar with both candidates. Investors have also welcomed the commodity boom and the determination with which the Central Bank of Brazil has acted (positive real interest rates, resilient real and net portfolio inflows). In 2023, once major central banks start to pivot and markets readjust their yield expectations, Brazilian sovereign bonds should yield positive returns. In the hard-currency environment, this will come from the reduction in the risk-free rate rather than by the spreads, where we expect a slight widening (above 300bps in 2023) as oil prices adjust further and concerns of fiscal policy grow. The first rate cuts and the control of inflation should bring yields of BRL-denominated bonds slightly down, but we do not expect them to go much below 11% in 2023 for the 5Y bond. Credit should benefit from easing monetary policy but fundamentals will keep spreads wider than necessary (~400bps). For equities, short-term cyclical momentum will feed into 2023 (~0-5% yearly return) but will start losing steam by year-end due to lower structural economic growth beyond 2023.
- **Public debt is the true winner of this election. Investors will be watching for fiscal soundness.** Beyond what comes next from the Federal Reserve and from oil prices, domestic fiscal policy will play a crucial role. We analyze the programs of both candidates Lula and Bolsonaro and find that the expansionist measures (social transfers, tax cuts, yet another revision of the spending cap) would lead to a deterioration of the primary fiscal deficit to -1.9% of GDP in 2023, the worst in 20 years (excluding the pandemic). This also means that Brazil will reach a 100% debt-to-GDP ratio by 2026. In addition, some fiscal measures may cause more inflation: We expect headline inflation at 5.1% in 2023, against the central bank's target of 3.25%, while real GDP growth will weaken to +0.8% in 2023 and return to close to its potential in 2024 with 1.9%. We expect the BCB to hold the Selic rate at 13.75% in 2022 and to start to lower it in H2 2023, bringing interest rates to 12% by the end of the year.

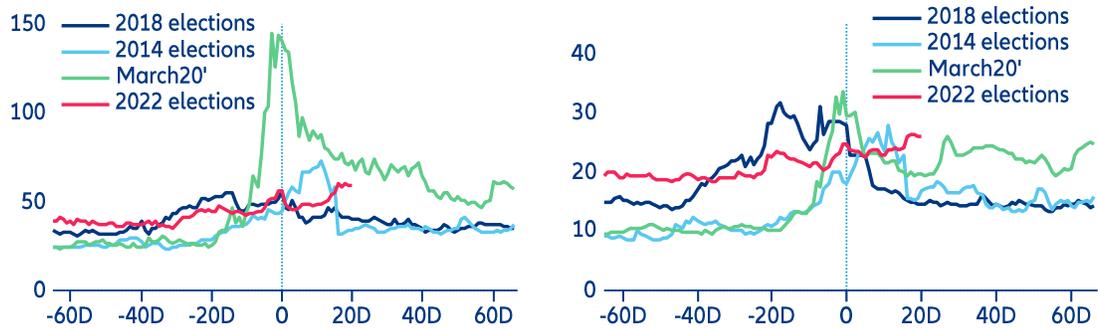
What are markets telling us about the outcome of the Brazil elections?

Although market volatility has been structurally higher due to the challenging macroeconomic environment, the divided 2022 Brazil elections have not created any meaningful additional stress. The current situation is neither comparable with other tense moments in Brazil's recent financial history, such as March 2020, or to the oil price collapse of 2015-16 (lower levels than during Covid-19, but longer-lasting in time). In 2014, the turmoil

came after the first-round results, and in 2018 prior to the first; both moments have already taken place in this election cycle and markets have not responded violently.

Both candidates, Luiz Inacio Lula da Silva (or more commonly known as Lula) and incumbent president Jair Bolsonaro, are well-known and although there are concerns on both sides, markets expect that neither candidate will fundamentally alter the current environment. Furthermore, the results of the Liberal Party (PL) in the Congress ensure a right-wing majority that would diminish the executive power of Lula should he – as the polls suggest – become the next President of Brazil. Judging by the reaction of Brazilian assets, the markets welcomed the first-round outcome.

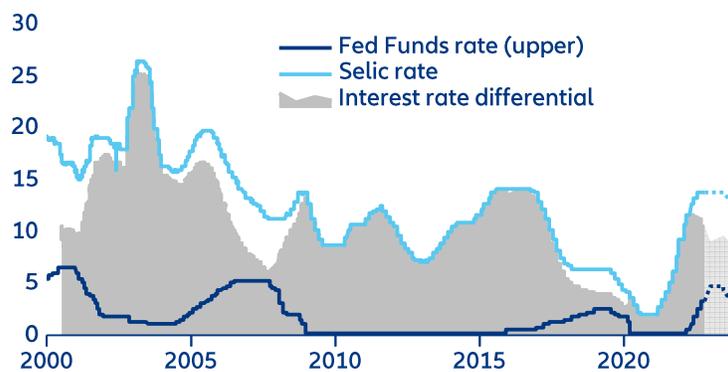
Figure 1: Pre-election volatility compared to previous events (LHS: Equity volatility, RHS: BRLUSD 1M implied volatility).



Sources: Refinitiv Datastream, Allianz Research. Date 0 corresponds to the first round of the elections; runoffs were needed after the three elections represented and are typically held three to four weeks after.

Brazil was one of the first countries to fight the post-Covid inflation and it has even been among the fiercest, even though its relative situation after the war in Ukraine has improved compared to the rest of the world. As a result, it now has positive real interest rates, has not succumbed to the strength of the US dollar and has attracted net portfolio inflows so far this year. Only a handful of countries have accomplished this, even including commodity exporters that should otherwise have benefited from the surge in prices.

Figure 2: Brazilian real rates. BCB quick reaction

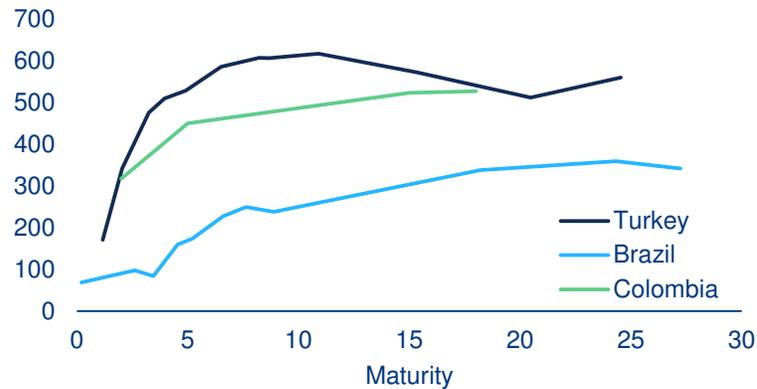


Sources: Refinitiv Datastream, Allianz Research. Dotted lines and shadowed area correspond to the Allianz Research forecasts.

Predictability, stability and orthodoxy do matter.

How does Brazil compare to other emerging markets? In March 2021, when Brazil implemented its first rate hike, President Erdogan replaced the head of the Central Bank of Turkey. Since then, Brazil's sovereign spreads have widened by 7bps while Turkey has endured turmoil that lifted spreads above the 800bps. Similarly, the Brazilian real has appreciated 6% vs. the USD, while the Turkish lira has lost more than 50% of its value.

Figure 3: Comparison of spreads along the USD-denominated sovereign curve

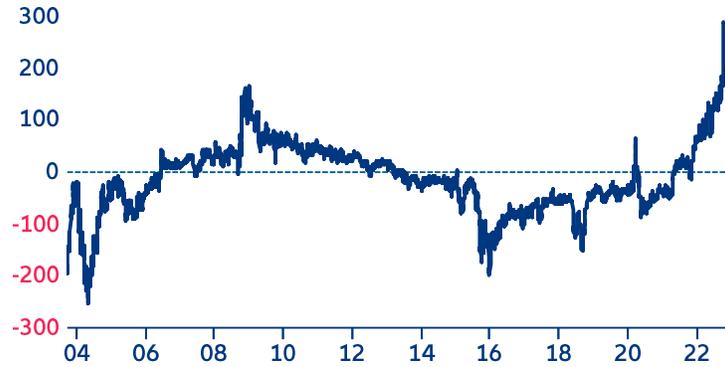


Sources: Bloomberg, Allianz Research.

In the same period, Brazil's northwestern neighbor Colombia – geographically, culturally and economically closer to Brazil than Turkey – has seen a fiscal package aimed at bringing down the fiscal deficit withdrawn amid street revolts, a rating revision to non-investment grade by S&P and a leftist president taking over. Even as petroleum represents the largest share of the country's exports, its currency has lost more than 10% against the USD in this year. Colombia's sovereign risk has also seen a significant repricing (Figure 4): Since 2021, Colombian USD spreads have widened severely compared to Brazilian ones.

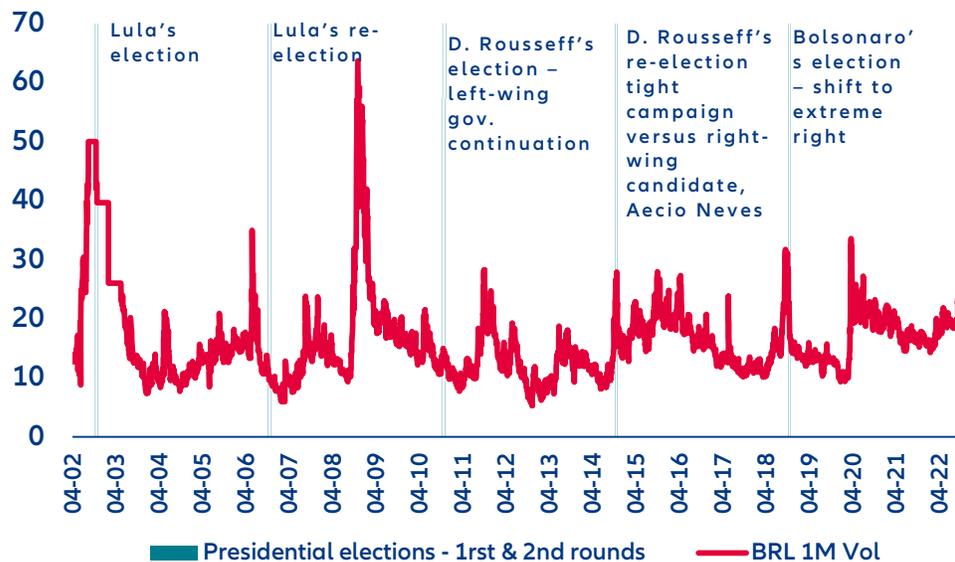
It is here that idiosyncratic factors play a key role. Like Brazil, Colombia also had presidential elections in 2022. The elections took place in June and pointed to the victory of the left-wing candidate, Gustavo Petro, a turnaround in the Colombian political scene until then dominated by the right. Uncertainties regarding the economic policy to be adopted in the country have weighed heavily on the currency. The present Brazilian political framework, by showing two former presidents as candidates for the next government, offers less of a surprise to the markets. In fact, from Figure 5, we see that the Brazilian real (BRL) has been much less volatile during the current elections than in previous elections, when changes in government direction from left to right, or vice versa, were associated with higher volatility in the exchange rate.

Figure 4: Differential between Colombian and Brazil USD sovereign OAS (a positive difference indicates Colombian spreads are higher and vice versa).



Sources: BofA, Refinitiv Datastream, Allianz Research. Spreads from Index levels.

Figure 5: Brazilian Real (BRL) one-month implied volatility vs presidential elections



Sources: Refinitiv Datastream, Allianz Research.

Investors have welcomed the commodity boom but do not see downside risks of fiscal profligacy

The biggest concerns for Brazil are the further tightening of US financial conditions, oil prices (together with Chinese demand) and local inflation getting out of control. As long as there is no U-turn in Brazil's approach towards the rule of law, the main threats to its performance are external. As we see in Figure 6, the significance of global factors in explaining the movements in Brazil sovereign spreads is rising fast as the Fed tightening shakes bond markets all over the

world. We continue to expect a 4.75% Fed Fund Rate by year-end and 3.75% by 2023-end, which will only make things worse. We expect the BCB to hold the Selic rate at 13.75% in 2022 and start to lower it in H2 2023, bringing interest rates to 12% by the end of 2023.

Figure 6: Share of Brazilian USD spread movements explained by common factors



Sources: BofA, Refinitiv Datastream, Allianz Research.

Brazilian risky assets have shown remarkable resilience in 2022 compared to other major emerging markets. The Bovespa index is currently posting a ~9% year-to-date return while the S&P 500 and other developed market equity indices are showing a ~20% year-to-date correction. This comes with an additional 5% year-to-date outperformance of the Brazilian real vs the USD. Despite this, it is important to contextualize the starting point of Brazilian assets: 2020 and 2021 were extremely downbeat for Brazil as the country struggled with the pandemic. During these two years, the Bovespa posted an aggregate -10% return while the S&P 500 increased by as much as 47.5%. At the same time, the Brazilian real lost 38.5% vs the USD. The 2020-2021 performance divergence reveals that Brazilian and US assets are following different tempos: While Brazilian assets are recovering from a deep market and economic trough, US assets are correcting from a historical peak, making the 2022 initial market and economic conditions structurally different (Figure 7).

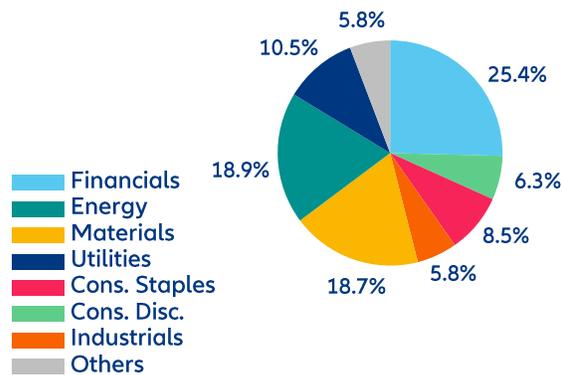
Figure 7: Brazil vs US equity markets and currency (year-to-date %)



Sources: BofA, Refinitiv Datastream, Allianz Research.

But different initial market conditions do not explain the whole story. The diverging tempo in monetary policy paths between Brazil and the big developed markets had and is having a direct impact on risky-asset performance and valuations. Looking back at 2021, when Brazil started its policy-hiking path and thus diverged from developed markets, risk aversion gained lots of terrain, leading to a big Brazilian market correction and currency depreciation. By the end of 2021 and especially in 2022, however, the sharp hiking cycle together with the extenuating commodity super-cycle aided risky-asset performance, launching both index and currency to a sharp and consistent recovery. In the case of equity markets, the relatively high concentration of financials (benefiting from higher interest rates and relatively low (though increasing for individuals) default rates – Figure 8) and commodity-driven sectors (benefiting from the commodity super cycle) has led to extreme resilience and outperformance. However, this raises concerns about the sustainability of the market rally and how fiscal and monetary policies may impact the recovery path moving forward (Figure 9).

Figure 8: FTSE Brazil – Sector decomposition (%)



Sources: FTSE, Refinitiv Datastream, Allianz Research.

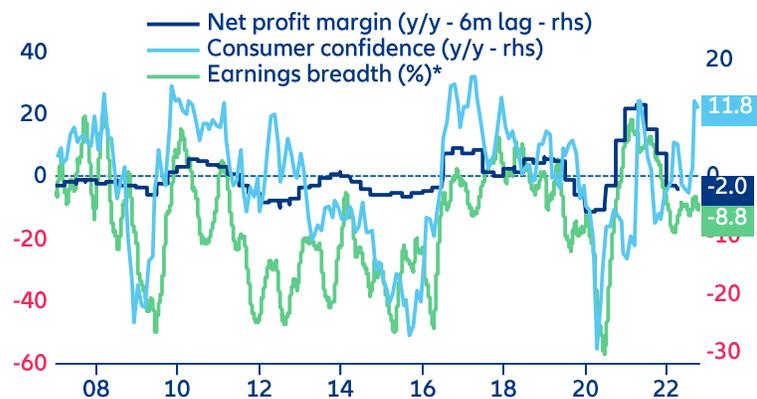
Figure 9: Brazil – Percentage of non-performing loans (%)



Sources: Refinitiv Datastream, Allianz Research.

Moving forward, the market focus will be on fiscal orthodoxy, the upcoming monetary easing cycle and the impact of the global economic slowdown. In 2023, the outlook should remain attached to the beginning of the easing cycle. After the second round, and irrespective of the winner of the elections, the degree of fiscal orthodoxy and the fiscal transmission will be key for market sentiment. However, and if the fiscal situation does not deteriorate further than expected, market stability should prevail in 2023, with most fiscal pushes being conducted through para-fiscal entities. At the same time, and with monetary policy becoming more accommodative, policy-sensitive sectors should provide a certain degree of cushioning versus the overall economic slowdown and the expected decline in commodity prices. The lower Selic rate should lead markets to trade sideways but with a mild positive tilt for most of the year (~0 to 5% total return for 2023). Beyond 2023, the outlook for risky assets should become more pessimistic regardless of who wins the presidential election as the structural weaknesses of the Brazilian economy should re-flourish, leading to meager long-term earnings growth and increasing fiscal imbalances. This not-so-positive outlook for risky assets in the mid-term will become even more pronounced if the slowdown and structural economic deterioration starts, once again, putting a lid on consumer sentiment as this would lead to a further erosion of companies' balance sheets on top of that already imported from the global economic slowdown (Figure 10).

Figure 10: Brazil – Net profit margins vs economic confidence and earnings breadth* (%)



Sources: IBES, Refinitiv Datastream, Allianz Research.

Note: * # of EPS upward revisions - # of EPS downward revisions as a % of total # of estimations

For credit, a similar mid-term outlook to that for equities should be expected, but in the short-run, easing policy rates will alleviate the pain. The early hiking cycle by the BCB put Brazilian corporates at risk as the prospect of higher financing costs and an uncertain macro environment led to a structural widening of corporate spreads well into 2022. However, in 2023 and together with equities, the prospect of laxer monetary policy paired with a still stable year should provide some cushion for credit risk to decline, and thus for corporate spreads to compress in 2023 towards 400bps vs 425bps currently. Beyond 2023, credit spreads will remain under pressure as companies' balance sheets and repayment capacities will be put to the test, leading to structurally wider spreads and an increasing amount of fallen angels (Figure 11).

Figure 11: Brazil – USD corporate spread decomposition (y/y change)



Sources: BofA, Refinitiv Datastream, Allianz Research.

Brazilian bonds have outperformed most traditional fixed-income assets. Although the sharp increase in inflation and reference interest rates caught many investors off-guard and turned 2022 into one of the worst years for global fixed-income returns, Brazilian bonds have fared better (Figure 12). Factors mentioned for other asset classes, such the real strength via balance of payments or the relatively low starting point, have contributed to this relative outperformance. As the markets are testing the renewed appeal of fixed income, Brazil’s bonds are set to yield positive returns again the second half of 2023. But the question is rather whether its relative performance vs. other fixed-income assets (and especially other EMs) would be worth it. There are many factors that the new Brazilian president will not be able to fix (such the Fed rates or the oil price), but fiscal policy will play a crucial role on the upcoming years. Our view is that in relative terms, and looking beyond the immediate short-term cyclical push, Brazil will underperform other emerging market peers on the back of unabated fiscal pressures. Interest rates will stabilize at high levels, so Brazil will continue offering interesting coupons, but with higher instability and risk.

Figure 12: Performance of selected fixed-income indexes vs. Brazilian USD sovereign (total return).



Sources: BofA, JP Morgan, Refinitiv Datastream, Allianz Research. A different selection of EM and Corporate indexes could lead to different results. Brazil Sov USD is part of the EM Sov HC.

“Nothing is so permanent as a temporary government program”^[1]

Fiscal policy will be a central issue in the next government regardless of the outcome of the presidential elections. When compared to Latin American peers, i.e. the LatAM-5^[2], the country's public debt ratio is significantly higher at 93% in 2021 (Colombia is second worst with 64%). The increase of the “Auxilio Brasil” cash-transfer program by R\$200 until year-end in an environment of low economic growth has further deteriorated the fiscal outlook. Inflation seems to have peaked, thanks to government measures such as a cut in fuel prices by Petrobras, in addition to the tax exemption on fuels and electricity. Inflation expectations have also been slowing on the back of slower economic growth and higher-for-longer interest rates. We still expect headline inflation at 5.1% in 2023 against the BCB target of 3.25%

Figure 13: Inflation and interest rates in Brazil (%)



Sources: Refinitiv Datastream, Allianz Research.

Figure 14: Key macroeconomic indicators for LATAM-5

		Brazil	Colombia	Chile	Mexico	Peru
Fiscal	Fiscal balance/ GDP	-4.42%	-6.84%	-7.49%	-3.80%	-2.55%
Inflationary risk	CPI	9.80%	9.40%	11.50%	7.80%	7.77%
Competitiveness	REER (deviation from the average of past 5 years)	-4.52%	-12.24%	-6.06%	8.88%	1.04%
Growth	GDP (average 2022-2023)	1.80%	4.20%	1.30%	1.40%	2.80%
External Sector Ratios	External Debt/GDP	48.70%	62.00%	69.00%	52.00%	48.00%
	External Debt/ Exports	181.40%	333.20%	218.20%	88.70%	135.30%
	Public Debt/ GDP	93.01%	64.60%	36.29%	57.56%	36.35%
	FX reserves (USD bn)	327.6	56.3	37.8	196.3	74.3
	CA/GDP	-1.90%	-6.10%	-8.50%	-0.80%	-3.60%
	Import Cover	12.2	8.2	6.0	4.0	14.3

Sources: Refinitiv Datastream, Allianz Research.

Amid spending increases and revenue losses, the next government will have to decide on whether to continue the newly implemented social welfare aid/tax cuts, and revise the spending cap rule. Both Lula and Bolsonaro have already indicated that the value of “Auxílio Brasil” will be maintained at the current R\$600. Note that the 2023 budget sent to Congress already includes such an extension. However, it does not include the readjusted amount (which would imply a total extra cost of R\$52bn, or 0.5% of GDP), and also includes the extension of the reduction of federal taxes on fuel. There is no fiscal space in the spending cap to accommodate all these demands, which means that adjustments will have to be made. Both candidates have already signaled they will make changes to the current spending cap, a mechanism created in 2016 to limit the growth of public spending to the inflation recorded in the previous year to keep public spending under control, which has allowed for a significant fiscal adjustment in recent years. This being said, since its inception, the spending cap has already undergone some changes and caused total expenditure to grow above the path originally set in the ceiling, undermining its credibility. One of the most recent was the “emergency PEC”, which made it possible to pay for the emergency aid and other expenses necessary to combat the Covid-19 crisis.

Below we track and quantify the fiscal impacts of both candidates' proposals, based on interviews and/or speeches given in recent weeks. In the tight race for the presidential seat, we notice a strong trend towards an increase in the overall “kindness package”. Key proposals are highlighted in Figure 15. Note we only specify expenditures on top of those already in the 2023 budget plan.

Figure 15: Proposals that should change fiscal policy

	Lula R\$ bn / % GDP	Bolsonaro R\$ bn / % GDP
Income Tax adjustment	21.5	32.6
% GDP	0.22%	0.34%
"Auxilio Brasil" - cash transfer program - expected changes		
Increase in value permanently to R\$600	52	52
% GDP	0.54%	0.54%
Extra R\$ 150 to child up to 6 years	18	na
% GDP	0.19%	
Thirteenth payment to women in charge of the family	na	10.2
% GDP		0.11%
Salary readjustment for all public servants	na	10
		0.10%
Total	91.5	104.8
% GDP	0.95%	1.08%

Sources: Several Brazilian Media (certainly not exhaustive, omissions remain ours), Inop, Allianz Research.

Figure 15 debunks the myth of a much greater spend under Lula’s presidency: Both candidates would lead to additional expenditures of at least R\$100bn, without matching revenues, on top of a fiscal deficit already expected at R\$64bn.

A few additional fiscal considerations:

- The Congressional renewal points to a center-right majority, with Bolsonaro’s Partido Liberal (PL) being the largest party in both houses, Chamber of deputies and Senate. This means that a Bolsonaro government would be more likely to pass measures in Congress than a Lula government in 2023. Counterintuitively, fiscal risks would then be higher under Bolsonaro than under Lula, despite the series of privatizations planned by Bolsonaro.

- Both candidates also contemplate a tax reform, which includes, on the one hand, the simplification of the system and the reduction of the tax burden, and on the other higher taxation of profits and dividends through income tax as a way to finance extra spending. Corporate profits are already taxed in Brazil, but their distribution to individuals have been tax-free since 1996.

No matter who wins, Brazil’s fiscal balance will deteriorate, and the debt-to-GDP ratio is set to increase to a record high level by 2026.

The increased spending of R\$100bn on average during the next term would lead to a primary deficit of -1.9% for 2023. This means a return to the levels seen in 2015-2017 and one of the worst fiscal performances of the last 20 years - excluding the exceptional effects of the Covid-19 pandemic (see Figure 16).

Figure 16: Primary fiscal deficit (% of GDP)



Sources: IMF, Allianz Research.

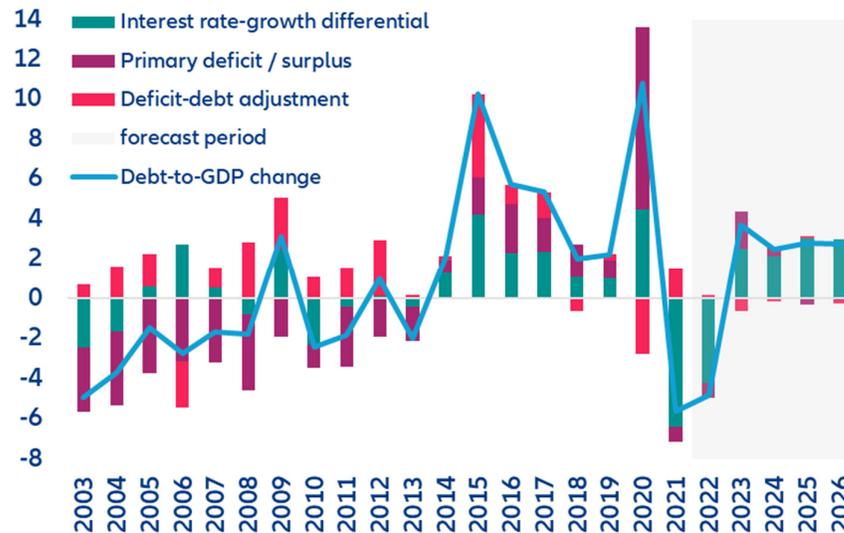
From Figure 17 we note that the primary deficit will therefore contribute positively to the increase of the debt-to-GDP ratio, especially in 2023 and 2024, and will start to contribute negatively to the increase of the debt-to-GDP ratio from 2025 onwards. Even so, the trajectory of public debt will continue upward, especially led by the notable gap observed between interest rates and real growth in the forecast horizon (see Figure 18), with the ratio reaching 100% in 2026.

Figure 17: Fiscal accounts forecasts

	Real GDP growth	CPI	Nominal GDP growth	Average interest rate on debt to be refinanced	Total interest expenditures (% of GDP)	Total primary balance (% of GDP)	Total fiscal balance (% of GDP)	Total debt (% of GDP)
2022	2.8%	9.6%	12.6%	12.0%	6.2%	0.8%	-5.8%	88.2%
2023	0.8%	5.1%	5.9%	9.9%	6.8%	-1.9%	-8.6%	91.9%
2024	2.1%	4.0%	6.1%	8.5%	7.3%	-0.5%	-7.7%	94.3%
2025	1.9%	3.3%	5.2%	8.1%	7.8%	0.3%	-7.5%	97.2%
2026	1.7%	3.2%	4.9%	8.0%	7.4%	0.1%	-7.3%	99.9%

Sources: Refinitiv Datastream, Allianz Research.

Figure 18: Brazil debt-to-GDP change and its underlying contributions



Sources: Refinitiv Datastream, Allianz Research.

Against this backdrop, it is clear that the next government needs to resume the reform agenda to address the fiscal impasse. The expenditure growth rule and the potential growth of the economy have significant impacts on these projections. Our baseline scenario considers economic growth close to its potential (+1.9%) starting in 2024, after +0.8% in 2023. Certainly, the adoption of a fiscal rule that is consistent with obtaining positive primary results and the adoption of reforms that enable the potential growth of the economy will be key to reduce public debt. Otherwise, Brazil's risk premium will certainly increase in the medium term, which will lead to lower growth, higher interest rates and consequently higher debt. The Herculean task at hand for the next President is clear and investors will be watching closely.

^[1] Milton Friedman.

^[2] Brazil, Colombia, Peru, Chile and Mexico

These assessments are, as always, subject to the disclaimer provided below.

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