Brazil Takes a Cautious Step Forward
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A deep recession and a massive corruption scandal have kept many investors away from Latin America’s biggest economy. But as a new government takes over in Brazil, we see some hope for the future.

For years now, good news from Brazil has been in short supply. The economy contracted by almost 4% last year and is expected to shrink again in 2016. Unemployment and inflation are above 10%. And a surge in public spending has swelled the fiscal deficit to unsustainable levels.

On top of that, a multibillion-dollar bribery and money-laundering scandal involving state-run oil company Petrobras has implicated hundreds of executives and politicians, lifting the veil on a pervasive culture of official corruption and making it nearly impossible for policymakers to address the economic malaise.

This political upheaval has been traumatic. But it’s also brought about some much-needed change, including a new government—President Dilma Rousseff has been suspended to face an impeachment trial for allegedly manipulating the budget—and new leadership at Petrobras and other major state-owned enterprises (SOEs).

A recent rally in Brazilian stocks and bonds suggests investors may be starting to look past the storm clouds that have long hovered over the country and focus on the silver linings.

The challenges ahead are big ones. But here are four things that give us cause for hope.

1. The government is emphasizing prudent policymaking….

Acting President Michel Temer has said his top priority is to reduce the fiscal imbalances that crowd out private investment and impede economic growth. To succeed, he’ll have to contain spending and find new sources of revenue. That won’t be easy, particularly since there’s little appetite in Congress for higher taxes.

The good news is that the new cabinet seems committed to spending less and is making the right noises about reforming the country’s bloated social security system. The system is a generous one that allows for early retirement and the indexing of pensions to the minimum wage, and that’s helped blow
the hole in the budget.

The government has a long way to go before public finances are back in the black. But this is a decent start. Additional spending cuts should give the central bank the space to loosen monetary policy and bring the benchmark rate down from its current perch above 14% to levels less likely to inhibit growth.

2. And a market-oriented approach at state companies.

The new government also wants to strengthen the balance sheets of important SOEs. Petrobras is off to a good start. The oil giant has been selling noncore assets, reducing capital expenditures and installing a more favorable pricing policy that ends consumer subsidies. It has also shifted toward longer-term financing by using the proceeds from new longer-maturity bonds to retire outstanding short-term debt.

New managers at other SOEs are moving in the right direction, too. A move to limit the role of subsidized lending at state banks, for example, should help eliminate distortions in the credit markets and allow rates for businesses and consumers to fall.

3. The judiciary is proving its independence.

The Petrobras scandal thoroughly tarnished the reputation of Congress and President Rousseff. Not so the third branch of government—Brazil’s judiciary. Throughout, judges have been able to prosecute powerful politicians and businessmen without impediment. When the government tried to stop the impeachment process to protect Rousseff, the judiciary wouldn’t allow it, ensuring a peaceful transition of power.

In other words, the constitutional process worked as it was designed to—even during a crisis. Other institutions—the police, the media—also did their job well. That’s a badge of honor for any country, let alone one that’s relatively new to democracy. What could have been a messy situation was handled with maturity.

4. Voters are fed up with corruption. Politicians and business executives are getting the message.

According to Transparency Brazil, more than half of the members of Congress face legal challenges. That has understandably infuriated voters and sparked protests across the country—so much so that it’s going to be hard to keep anticorruption efforts off the agenda.

A case in point: companies are getting serious about rooting out fraud. Many have put into place specific measures to improve corporate governance and compliance. These include hiring international accounting firms to improve compliance procedures, engaging independent counsel to investigate allegations of employee wrongdoing and improving whistleblower procedures.

These developments are encouraging, and investors are starting to reprice overall country risk. Those who have avoided Brazilian assets lately may want to take another look.
In fixed income, the rebound in the real suggests pockets of value in local-currency debt. Some corporate debt also looks attractive at current prices. We see value in equities, too, though we think it’s important to be selective and seek out company-specific opportunities. Companies with strong cash flows and pricing power look attractive, as do firms with improving fundamentals whose business success does not hinge on a particular political outcome.

We’d still like to see lawmakers put their disputes aside and pass a series of reforms, including legislation that would make it easier for companies accused of corruption to pay a fine and resume operations. But if Brazil keeps up the reform momentum and starts to attract more private investment, we’ll expect to see domestic interest rates fall, sovereign yield spreads narrow and equity markets rise.

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