OPALESQUE

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Benedicte Gravrand (gravrand@opalesque.com) thought of you and forwarded this article to you:

"Dear Claudia,
This article will be in tomorrow's newsletter.
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Benedicte"

The Big Picture: Claritas Investimentos cautiously optimistic about Brazilian economy, equities, real

Benedicte Gravrand, Opalesque Geneva:

A lot has happened in Brazil this year; allegations against dozens of senior politicians linked to the Petrobras scandal, the brief detention of former President Luiz Inácio Lula da Silva (also linked to state-oil company Petrobras), street protests, Dilma Rousseff's impeachment, the Olympics and Paralympics, and Michel Temer becoming interim president. Meanwhile, the Latin American country experienced rising unemployment, weakening currency, GDP contraction and ongoing inflation. But according to some, if the new government does what it set out to do, it might improve both the economy and investor sentiment.

Recent developments

Brazil's senate voted by 61 to 20 to remove president Dilma Rousseff from office on August 31st. She was charged with tampering with government accounts to conceal the size of the budget deficit. Michel Temer, who had been interim president since May, was sworn in hours later to serve until elections in October 2018.

Temer wants to revive the economy with policies different from Rousseff's, and push for privatisation, deregulation and fiscal discipline.

Since he took charge, the Sao Paulo stock market and the Brazilian Real have strengthened and the cost of insuring government bonds against default has fallen by a quarter, said The Economist.

According to R-Squared Macro, a US-based research and investment house, the ongoing recession in the country - twice the central bank's target of 9% - has prompted investor flight. But "several economic indicators have improved under Temer, including consumer and corporate confidence, retail sales, and industrial production. Looking ahead, this momentum will likely continue if Brazil's leadership can shrink its fiscal deficit — currently 10% of total GDP — through austerity measures." Investor's confidence in Temer is crucial to the Real appreciation and therefore to inflation. In the end, Rousseff's impeachment could mark a potential upswing in Brazilian sentiment, paving the way for more active monetary policy.

First, focus on fiscal agenda

Damont Carvalho, macro fund manager at Claritas Investimentos, a Brazilian fund management firm, believes that now the impeachment has been approved, the attention will move to the fiscal agenda. Not much has been done so far for various reasons, but new policies are being looked into.

Since May, Temer has stabilised expectations with a qualified and credible economic team, and the government is committed to stopping the deteriorating fiscal trend and start fiscal reform, he told *Opalesque*. But so far, "the government has actually announced measures that raise public spending, aggravating the fiscal imbalance." It was trying to balance budget tightening, satisfy politicians needed to approve the impeachment, and pass measures designed to improve investor confidence and fiscal accounts.

The government claimed that they would be able to pass unpopular fiscal measures only after the impeachment. And that the fiscal situation inherited from the previous administration was worse than expected.

"For us, once the impeachment process is concluded, Temer´s honeymoon is over and the Temer administration no longer has an excuse to keep on postponing the fiscal adjustment, and must address important fiscal measures in the next months," Carvalho says.

"Temer is expected to take decisive action against the salary rise for Federal Supreme Court (STF) justices, whose ripple effect over other careers may reach an impact of as much as BRL4.5 billion (US$1.36bn)," he continues. His administration's withdrawal of support for the salary rise would indicate what its priorities are.

The president is also expected to increase negotiations with congressmen in order to accelerate the approval of fiscal reforms. Currently under review is the spending cap set by the Constitutional Amendment. The review is expected to be approved by the senate by year's end, but Carvalho believes it might be delayed or changed, especially with regards to health and

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education spending. Once that's done, the government is also expected to prioritise the reform of social security. Given the tight time-scale, this may not happen before next year.

The government should also focus on stimulating investments in infrastructure, to fuel economic growth, through the Investment Partnerships Program (PPI), which was approved at the end of August. This program will be announced in the next weeks.

"While the government tries to approve the fiscal agenda in the Congress and boost an investment cycle in Brazil, the good news for the government of Michel Temer are that a monetary easing cycle is likely to start in the second half of the year and that the GDP already shows signs of stabilisation," Carvalho continues. "On the monetary front, besides the deep recession, the expectation that Michel Temer administration could show fiscal progress helped anchor the Real and improved inflation expectations. Regarding economic activity, Brazil´s GDP contracted less than expected in the first half of 2016 and the increase in the confidence indices indicate that the worst of recession is behind us. For 2017, the optimism about the fiscal agenda of Michel Temer administration has already increased the median forecast for GDP."

Brazil's economy growth decelerated in 2013 and the country entered an ongoing recession in 2014: its GDP plummeted to -4% earlier this year - after reaching a high of 7.5% in 2010. The World Bank expects it to go back up to 0.8% in 2018.

Opportunities

Brazilian assets have already rallied this year, and Carvalho believes there are further opportunities for the country.

The Ibovespa rallied this year while earnings were depressed, he says. "However, we believe that with a gain in consumer and entrepreneur confidence, a lower internal interest rate and the bottoming on economic data, we expect to see a non-linear growth for company earnings due to operational leverage. Therefore we are cautiously optimistic for Brazilian equity markets."

The Ibovespa Brasil Sao Paulo Stock Exchange Index is up 34% YTD. Currently at 58,095, it was 57,200 five years ago (and about 53,500 in early May).

Bonds' local interest rates have room to decline in the next quarters as inflation decelerates, Carvalho continues. He likes internal nominal rates (Brazilian bonds NTN-F, LTN, derivatives) focusing on the beginning of the easing cycle. As for real rates, he prefers the long end of the yield curve (NTN-B 2050 maturity).

"On the currency scenario, we believe that we will live a long period of low global interest rates with a range in prices of international commodities," he adds. "Therefore, we still believe that we have juice to hold carry trade, favoring emerging markets currencies. We are cautiously optimistic in the BRL.

"In general, for investors, we always believe in portfolio's diversification, to minimize the risks and taking advantage of all types of investments."

Claritas Investimentos manages equity funds, balanced funds and managed accounts. Its Brazil Long/Short Market Neutral offshore hedge fund returned 0.99% in August (-1.6% YTD), while its Brazil Equity Value offshore fund made 1.5% (56.6%). US asset and pension fund manager Principal Financial Group acquired 60% of the Sao Paulo-based firm in 2012.

The Eurekahedge Latin American Hedge Fund Index is up 15.7% YTD (to end-August), compared to the Eurekahedge Emerging Markets Hedge Fund Index, which is up 6.7%.

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