Dilma 2.0

LATIN AMERICA'S BIGGEST ECONOMY NEEDS A LIFT. WHETHER IT GETS ONE WILL LIKELY DEPEND ON ACTIONS PRESIDENT ROUSSEFF TAKES EARLY IN HER SECOND TERM.

BY JESSICA BRICE AND FILIPE PACHECO

Rousseff was re-elected by a margin of 4 percentage points—Brazil's closest presidential race in years.

In early October, a few weeks before Brazil's closest presidential election since the country's return to democracy in the 1980s, 100 executives gathered at an American Chamber of Commerce event in Sao Paulo for another sort of vote. When polled about the country's economy, more than half of the attendees said their outlook would improve—as long as President Dilma Rousseff lost her re-election bid. Two-thirds expected economic performance to worsen if she earned a second term.

It's the lack of confidence in Rousseff's leadership—amid high inflation, currency interventions and deteriorating fiscal accounts—that investors say will be her biggest challenge. Rousseff, who prevailed by a margin of 4 percentage points on Oct. 26, must now try to stave off a credit-rating downgrade and revive growth in Latin America's biggest economy, which slipped into a recession in the first half of 2014. "She has tremendous challenges ahead," says Ricardo Sennes, a partner at political risk consulting firm Prospectiva in Sao Paulo. "She has to stop the slide in her credibility."

The markets—contrary to expectations—have given Rousseff some breathing room. Far from the "collapse" one partner at a Rio de Janeiro–based hedge-fund firm predicted following a Rousseff victory, the Ibovespa stock index fell just 2.8 percent the day after the election—and rebounded 3.6 percent in the next session. By the end of the week, stocks were up 5.2 percent. Some investors said a surprise interest-rate hike three days after the election showed the central bank is ready to get tough on inflation.

One person Rousseff can thank for her second-term grace period is U.S. Federal Reserve Chair Janet Yellen. At a Paris conference on Nov. 7, Yellen urged the world's central bankers to "employ all available tools" for supportive policies that encourage growth. If policy makers follow her lead and keep interest rates low, Brazil may continue to benefit from overseas investors seeking higher returns. With real interest rates above 4.5 percent—the highest among Group of 20 nations—yields on Brazilian sovereign bonds are still attractive.

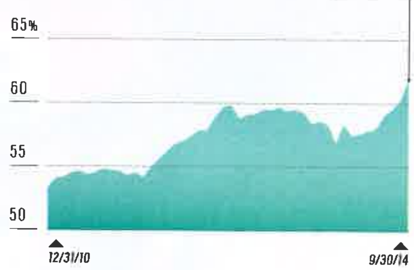
The general unease about the Brazilian economy may even be a buy signal. "There are investors who think this is the perfect time," says Christopher Meyn, head of private equity at JPMorgan Chase & Co.'s Gavea Investimentos Ltda., based in Rio de Janeiro. "Everything is crappy, everyone is bummed, nothing is as it could be; this is when you go to town."

Meyn says valuations in some sectors

Dilma's Difficulties Distilled

Increase in Debt-to-GDP Ratio
The government's budget deficit widened to a record in September.

61.7%

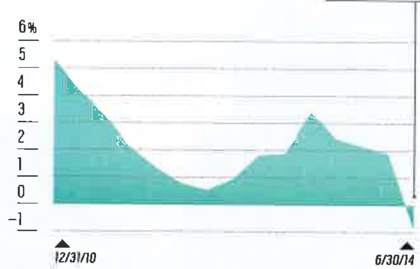


Persistent Inflation
Inflation remains above the 4.5 percent midpoint of the central bank's target range.

6.6%

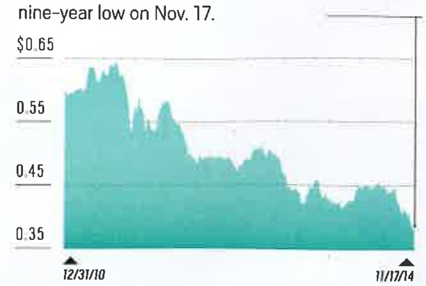
Weakening Economic Growth
Brazil's economy slipped into a recession in the first half of 2014.

–0.9%



Currency Decline
The U.S. dollar has drubbed the Brazilian real, which hit a nine-year low on Nov. 17.

R$1 = $0.38



Source: Bloomberg

are attractive. "It could be one of the best private-equity cycles ever if you make the right value investments over the next couple to three years and things recover in five or six," he says.

After all, there's a lot to like about the world's fifth-largest country, in terms of both territory and population. Its offshore oil reserves include the Western Hemisphere's biggest discovery since 1976. It has the world's second-largest iron ore reserves and ranks No. 2 in soybean production and No. 3 in corn. Average real monthly income jumped 34 percent in the past decade, and as the middle class has swelled to more than half the population, people now have access to credit to buy their first homes and cars. In total, some 36 million Brazilians have emerged from poverty since 2003, according to the government.

Still, investors say Rousseff needs to move quickly. "There's a window now, but that will change," says Fausto Gouveia, who helps manage 850 million reais ($330 million) at Azimut Holding SpA's AZ Legan unit. "American rates will eventually rise, and European rates won't stay so low forever. If the right signals aren't given, foreign investors are ready to press the sell button. They'll leave Brazil."

At the outset of 2014, about 100 economists in a weekly central bank survey predicted growth of 1.95 percent in 2014 and 2.5 percent in 2015. Shortly after Rousseff won her re-election bid, those estimates plunged to 0.21 percent and 0.8 percent, respectively.

Among Rousseff's most pressing tasks is aggressively fighting inflation and addressing a budget deficit that swelled to a record 69.4 billion reais in September. Investors want the central bank to stop intervening in currency markets and let the real devalue so that manufacturers can become competitive again. They also want her to stop meddling in the private sector, in part by eliminating price caps on gasoline, electricity and other goods that have destroyed billions of dollars in the market value of companies. And she must restore confidence in Petroleo Brasileiro SA, the state-controlled company she chaired from 2003 to 2010 and that is now in the midst of an escalating corruption scandal. Do all that, they say, and Brazil can attract more private capital to bolster an investment rate that's the lowest among major economies in Latin America.

Investors' biggest concern remains Rousseff herself, who vowed "to be a much better president" in her acceptance speech.

> 'THERE ARE INVESTORS WHO THINK THIS IS THE PERFECT TIME,' SAYS CHRISTOPHER MEYN OF GAVEA INVESTIMENTOS. 'THIS IS WHEN YOU GO TO TOWN.'

"This government has lost the benefit of the doubt among markets, investors and the private sector," says Claudio Mifano, a partner at Sao Paulo–based Claritas Investimentos, with 3.2 billion reais in assets under management. "Just speeches will not be accepted anymore."

Mifano says Rousseff sees the government, not the private sector, as the biggest engine of growth. A former Marxist guerrilla who was imprisoned and tortured for three years under Brazil's military dictatorship in the 1970s, Rousseff, 67, studied economics at the State University of Campinas—in a department known for its socialist ideology. Her predecessor, Luiz Inacio Lula da Silva, a labor leader turned market darling, was a pragmatist who let his advisers fight it out to come up with the best economic policy.

Rousseff, by contrast, is more dogmatic, says Raul Velloso, a Yale University–educated economist and columnist for newspapers *O Estado de S. Paulo* and *O Globo*. "She simply does everything the way she wants," he says. "She manages and controls all the processes. You don't see people being delegated

Stretches of the **BR-163 highway** remain unpaved, impeding transportation of soybeans—a major crop.

LALO DE ALMEIDA/THE NEW YORK TIMES/REDUX

Price caps have forced **Petrobras**—embroiled in a corruption scandal—to sell imported fuel at a loss.

FRANCESCO ZIZOLA/NOOR/REDUX

functions and making decisions. Everything is tied to her." Rousseff and the presidential palace's press office didn't respond to requests for comment on this article.

As public spending surged in Rousseff's first term, so too did inflation. Consumer prices rose 6.6 percent in October from a year earlier and have remained above the 4.5 percent midpoint of the central bank's target range for the past four years.

Standard & Poor's in March downgraded Brazil's credit rating to one level above junk, citing the slowdown and deteriorating fiscal accounts. Moody's Investors Service signaled it could also cut Brazil's credit rating to the cusp of junk when it lowered the outlook to negative in September.

Rather than rein in spending, Rousseff has relied on government intervention to suppress consumer prices. The government limits prices for more than a fifth of the products included in the consumer price index. Gasoline price caps have forced Petrobras to sell imported fuel in the local market at a loss, contributing to a slide in the market value of the state-run oil company of more than $169 billion during Rousseff's first term.

In 2012, Rousseff forced electric utilities to agree to cuts of up to 70 percent in regulated prices as a condition of renewing contracts to supply hydroelectric power. In 2014, amid a punishing drought that dried up dam reservoirs, wholesale prices skyrocketed, and the government had to extend at least 17.8 billion reais in bailouts to distributors, who are prevented from passing on the higher prices to consumers.

The central bank has stepped in by selling currency-derivatives contracts to defend the real and prevent a weaker currency from further fueling inflation. The swaps—the equivalent of selling dollars in the futures market—allow buyers to hedge against a plunge in the local currency. Since August 2013, when Brazil began selling the currency swaps, the contracts have climbed to $104.5 billion, or 28 percent of foreign reserves.

All these policies have contributed to a decline in private investment. Shrinking investments accounted for the bulk of the contraction in gross domestic product in the second quarter from the previous three months, the national statistics agency says.

Manufacturers have suffered the most. In January 2003, at the start of Lula's first term, manufactured goods made up more than half of Brazil's exports. As of October, they had fallen to about a third, while commodities now make up half. Brazil's 12-month trailing trade surplus has tumbled from a record $47.8 billion in May 2007 to $2.52 billion in October. That trend accelerated as Chinese demand for raw materials slowed and prices of commodities such as iron ore and soybeans plunged. "If you put all of this together, no matter what you look at, there's nothing that's going to make you jump out of your seat and go, 'Jeez, this is where in Brazil real growth will be more than zero or 1 percent,'" Gavea's Meyn says.

Among Rousseff's biggest challenges will be tackling macroeconomic fixes while keeping her base and the growing middle

BLOOMBERG TIPS

Monitoring Investments in Brazil

To track yields on Brazilian debt, type **SOVM BR <Go>** for the Sovereign Debt Monitor function. Yields on local 10-year bonds soared to 12.9 percent on Nov. 14. Click on a figure in the Yield column for a chart. To follow private-equity deals in Brazil, you can use the Mergers & Acquisitions (MA) function. Type **MA PELATAM <Go>** for a ready-made search for deals with Latin American targets. Click on the Edit Search button on the red tool bar. Type 101 <Go> and then 11 <Go> to delete the regional criteria. Click on the plus sign to the left of Latin America & Caribbean to expand the list. Click on Brazil and then on Update. Click on Results. **JON ASMUNDSSON** class happy, says Christopher Garman, head of emerging-markets research at political risk consultancy Eurasia Group.

As Rousseff's lead narrowed in polls ahead of the October elections, she courted voters by reminding the middle class of the gains they have enjoyed under 12 years of rule by her Workers' Party, known as the PT. And there have been many. The PT's social welfare programs benefit Brazilians from shantytowns to the far reaches of the Amazon, from students to workers. Spending on the flagship cash-transfer program, Bolsa Familia, which aids almost a quarter of the country's population of 200 million by providing monthly payments to low-income families, has surged by 64 percent in inflation-adjusted terms since Rousseff took office in January 2011, government data show.

Rousseff's administration also paid for 8 million students to receive vocational training, keeping younger Brazilians out of the workforce and therefore reducing the jobless rate. Unemployment at a near-record low of 4.9 percent in September was a key selling point in Rousseff's re-election campaign.

Social-spending promises made during the campaign undermined her credibility on fiscal discipline, Garman says. Rousseff in June boosted Bolsa Familia cash transfers, and she has also said she will increase income tax exemptions for 2015 and has pledged to continue raising the minimum wage.

"The dilemma of middle-class politics is a particularly acute one for Brazil," Garman says. "Investors and markets are asking the government to tighten fiscal policy after a period of some slippage on fiscal accounts. But politically, the middle class is becoming larger and more robust, and what they are demanding is for more spending. There's tension."

Brazil is a world leader in hydroelectricity. Its **infrastructure**, however, has room for improvement.

STRINGER/BRAZIL/REUTERS/CORBIS

> 'THE MIDDLE CLASS IS BECOMING LARGER AND WHAT THEY ARE DEMANDING IS FOR MORE SPENDING,' EURASIA' S GARMAN SAYS. 'THERE'S TENSION.'

With Brazil's total tax burden at 39 percent of GDP, Rousseff has little room to boost revenue through levies to help cover the budget gap. And companies aren't likely to lead the rebound either, with Brazil coming in 120th out of 189 in the World Bank's ranking of countries by the ease of doing business.

Brazil's investment rate, which includes money for roads and public transportation, is 18 percent of GDP, according to the World Bank. That's the lowest figure among major economies in Latin America and less than half China's 49 percent. The country's quality of infrastructure also ranks 120th out of 144, behind Honduras's, Pakistan's and Ethiopia's, according to the World Economic Forum.

Joshua Duitz, a Purchase, New York–based money manager at Alpine Woods Capital Investors LLC, who manages four funds totaling $1.6 billion, including investments in Brazil, says Rousseff's "short-term signals will really set the tone for investors believing that she has turned a new leaf." The question is, Duitz says, "does she see this as an opportunity to right some of the wrongs, some of the missteps that plagued her first administration?" She has time to prove herself—but not much.

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