1 April 2021

KALEIDOSCOPE

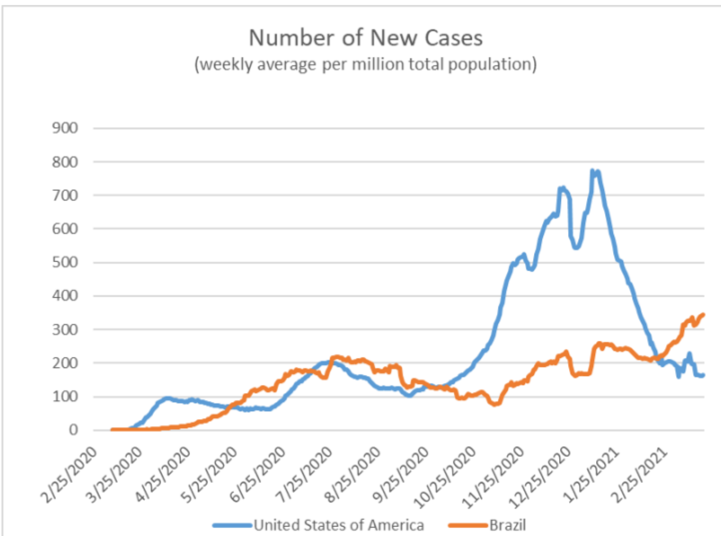
What Markets are Missing Beneath Brazil's Messy Headlines

Ricardo Adrogue, Boston

Brazilian fixed income markets have been under quite a steady selloff so far this year, the currency returning -9%, the local bonds selling off by 170 bps, and the USD bonds returning -6.6% based on JPMorgan Brazil EMBIGD sub index—arguably one of the worst EM performers year-to-date.

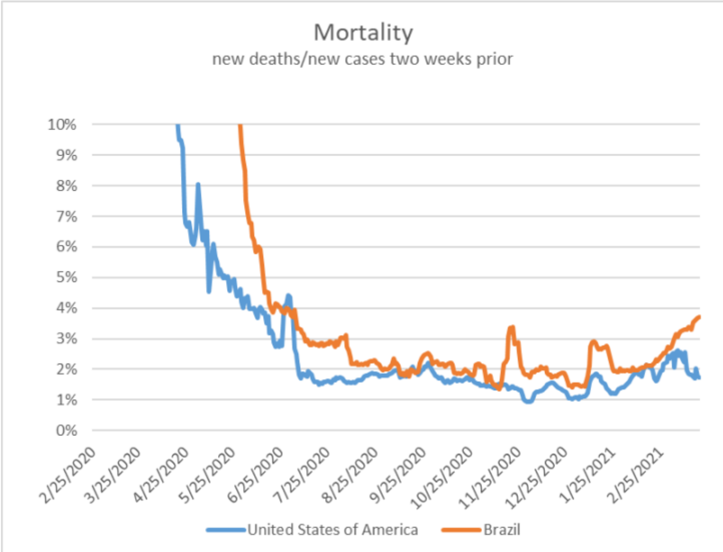
While a lot of things have gone wrong for Brazil—a particularly virulent pandemic, President Bolsonaro's disregard for the management of state-owned petroleum giant Petrobras, and the reversal of former President Lula's corruption conviction—it is fair to say that the gap between market prices and economic fundamentals has gone too far.

The pandemic has wreaked havoc in terms of infections and deaths. Bolsonaro's leadership has been lacking, with the pandemic and broader management of the country—or so it is believed. Statistics will show, however, Brazil has had a better pandemic experience than the U.S., so far at least; as the chart below illustrates, the number of cases per million in Brazil have in large part lagged or at least have been on par with those in the U.S.



Source: World Health Organization (WHO), Barings LLC

Death rates in Brazil have been slightly higher (3% versus 2% in the U.S.), with around 2,000 daily COVID-related deaths in Brazil.



Source: World Health Organization (WHO), Barings LLC

But the markets seem to be paying too much more attention to recent COVID trends and too little to the country's fiscal management. Actual economic releases, including activity and employment figures, balance of payments, and fiscal results, all point to a robust, healthy economy that is on the mend from a devastating health crisis.

So why are Brazilian assets underperforming? The market is concerned about fiscal risks, but these are likely exaggerated. The biggest apprehension seems to be a sharp turn to economic populism that would put Brazil on an unsustainable spending path. Unfortunately, near extinction of the finance minister's powers does not help, and Bolsonaro's economic convictions may not be overly orthodox. Add in the legal reversal of a ruling against former President Lula, a leftist with great popularity, which had prevented him from running in the October 2022 elections, and investors' conclusions are clear: run before it's too late!

Are things really that bad? A turn to populism can certainly not be discarded, but congressional actions over the past two months point to a more constructive path. After almost a year of no meaningful congressional votes (not even the 2021 budget was approved), the new congressional leadership has passed important legislation with remarkably large majorities:

- central bank independence;
- expanded pandemic support that also establishes rules that make finances sustainable again;
- the 2021 budget, in which public expenditure as a percentage of GDP is under control, particularly in light of its expansion in 2020 driven by the vigorous pandemic response;
- a water and sanitation bill that requires states to renew licenses via a public competitive-bidding process.

While these reforms are not 100% watertight, and some could be used in a manner that is contrary to their stated objectives, the expectation that they will be used incorrectly or maliciously seems like a figment of the imagination, especially in the context of a healing economy.

An alternative explanation for underperforming Brazilian asset prices could be fears the pandemic triggers an institutional break in the country's governance. President Bolsonaro's popularity is very low, especially among the elite. But it is important to put the current sociopolitical environment in perspective. Brazil is a well-established democracy that has had clean, popular elections since 1988. Political leaders there have weeded-out corruption by impeaching two presidents in the past 40 years, without causing institutional damage. Moreover, congressional voting has not shown the degree of cohesion in key policy matters in a very long time. Not only was Congress able to pass constitutional reform that requires 2/3 of both houses on two separate votes in record time, it also passed the budget with a much larger majority than the 50% required.

A third potential concern is the region's overall policy direction. Elections in Mexico, Argentina, and Bolivia have gone to less market-friendly candidates; April elections in Ecuador and Peru raise similar concerns. Is the Cuban-Venezuelan governance structure where Latin America is heading as a region? Can Brazil be spared? Again, while this risk is real and regional trends have precedent (military dictatorships in the 1970s and 80s, electoral swings from left-to-right and back again), elections in Brazil will not be held for another 18 months. Yes, there is some wasted fiscal space that may be costly in an election year, where spending will likely increase again, but it seems too early to price this risk with any clear certainty at this time.

Finally, rising U.S. Treasury yields represent a headwind for funding conditions in Emerging Markets. While Brazil is not an exception, the country's foreign financing needs are close to negligible. As a less-open economy, it could pay its external obligations easily out of exports and has chosen to hold large amounts of international reserves, which represent five-times its short-term external debt and two-thirds of its total external debt (public plus private). Moreover, Brazil's external current accounts is now balanced despite a much milder contraction than its trading partners in 2020. Rising U.S. Treasury yields may therefore reduce the total availability of foreign funding for Brazil, but that would be a minor inconvenience, not reason for concern.

Brazil's politics are messy and its communication is poor, but the rules still work and the government can maintain control of the path. There is budget to increase social protection, and the deficit won't be explosive, particularly when the fiscal response is compared to the expected shock in the coming two years. It is united and working hard to address the health crisis within a sustainable economic framework. The rest is just noise… and maybe a great investment opportunity.

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed. Past performance is no indication of current or future performance. ***PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.*** *Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.*
For Professional Investors/Institutional Investors only. This document should not be distributed to or relied on by Retail/Individual Investors.

Barings LLC, Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sàrl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"), together known as "Barings." Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER:
The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved and before making any investment decision, it is recommended that prospective investors seek independent investment, legal, tax, accounting or other professional advice as appropriate.
Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

These materials are being provided on the express basis that they and any related communications (whether written or oral) will not cause Barings to become an investment advice fiduciary under ERISA or the Internal Revenue Code with respect to any retirement plan, IRA investor, individual retirement account or individual retirement annuity as the recipients are fully aware that Barings (i) is not undertaking.

**As of December 31, 2020*
21-1587324