Brazil: South America's fallen star

Host to the 2016 Olympics, Brazil's problems find an echo in questions about the stability of its political landscape. Here managers from Insight, ARX[1] and Standish discuss the Latin American outlook.

Brazil has benefited from the commodity cycle over the past 10 years but with Chinese growth starting to slow, demand for major commodities has declined, according to Rogerio Poppe, portfolio manager at BNY Mellon ARX in Rio de Janeiro. The Brazilian government had not put money aside for this moment and faces the challenge of reducing expenditure when the economy is shrinking and jobs are being lost. Raising taxes at such a time will also be a challenge.

The prevailing economic picture did not help President Dilma Rousseff, whose popularity was in rapid decline in the final months of 2015, comments Poppe. As the year drew to a close there was the distraction of talk about impeaching Rousseff, with the accusation levelled that Rousseff's government manipulated its accounts in 2014 to disguise a widening fiscal deficit amid the campaign for re-election. With questions of Brazil's leadership still looming, there is a need for political clarity, says Poppe.

Compared to the problems faced by some countries in the eurozone in 2011 (constrained by a common currency), Brazil's adjustment has been driven by market participants as its local currency had depreciated by around 50% against the US dollar over the past three years.[2] There are expectations that the trade balance surplus for 2015 will be in the range of US$30-40bn, says Poppe, adding the trade surplus had earlier been estimated at US$10bn. The weaker real is bolstering exports and the shrinking economy is reducing demand for imports.

A weaker currency will not necessarily help Brazil, which has a history of high inflation and hence limited room to manoeuvre, cautions Colm McDonagh, head of emerging market debt at Insight Investment. Interest rates were hiked substantially in 2015 to tame inflation, he notes.

Energy for reform

From 2002 through until the global financial crisis in 2008, Brazil engaged in positive reforms under President Luiz Inácio Lula da Silva and was the beneficiary of huge capital inflows, even to the point it had to take action to stop the real appreciating, comments McDonagh. In the past few years, the energy for reform has dissipated, with corruption scandals, such as those affecting Petrobras, (notably the 'car wash' scandal) hampering structural reform.

'Car Wash' is significant in so far that the Investigation is happening despite the government and is being conducted by federal police and subject to a low level of political interference, comments Poppe. *Operação Lava Jato* – literally 'Operation Car Wash'– has been partly responsible for bringing economic activity to a low level, he adds, with construction companies particularly affected amid allegations that they were beneficiaries of padded contracts. Over the next six to 12 months, an improvement in economic activity is likely as some of the construction companies have already paid fines and will be able to participate in future government concessions, says Poppe.

If the government is able to achieve a reduction in expenditure, increase fiscal revenues and fight off the return of inflation, the perspective is likely to be better in 2017, says Poppe. In 2016, the Brazilian economy is expected to contract 1.4%, with unemployment likely to peak in 2016, he adds.

The consensus is for a slow recovery in 2017/2018, with that recovery different from the recent past as consumers will not be significant contributors to GDP growth. It will take some years before consumers are able to help foster growth. Infrastructure investment could instead potentially be a driver of GDP, says Poppe. However, the infrastructure left by the Olympics is not likely to contribute significantly to the economy but it will have the advantage of showcasing the attractions of Rio on the world stage.

Besides Brazil, the region's largest economy[3], Latin America has top-tier economies, such as those of Mexico and Chile (less likely to be characterised as emerging markets) and the smaller and successful economies of Colombia and Peru, says McDonagh. In contrast, Argentina and Venezuela (in particular) are struggling because of the policies they have persued for some time.

Flexible exchange rates

Even with weaker oil prices (difficult for oil producers), most Latin American countries benefit from having flexible exchange rates, says McDonagh, with weaker currencies not necessarily a bad thing except for investors in local currency issuance. For instance, Colombia, a significant oil producer, recognises that allowing its currency to weaken enables it to deal with such trade shocks. In the past, economic surprises were absorbed by domestic GDP, which created balance of payment problems, debt and political difficulties. However, compared to other Latin American economies, Argentina and Venezuela lack the ability to weaken their currencies to deal with such economic shocks.

Mexico, which is closely linked to US fiscal and monetary policy, has engaged in structural reform over the past few years, has a flexible currency and is likely to be able to weather problems in emerging markets much more successfully than Brazil. Mexican policy makers are among those in Latin America that have their interest rates in synch with the US, says McDonagh. The extent of the US rate hiking cycle will determine its impact on Latin America, with a hiking cycle of less than 150-200 basis points unlikely to have a significant influence.

Dependence on oil

According to Javier Murcio, portfolio manager and senior analyst for emerging markets strategies at Standish, there are two main concerns around Venezuela – the dependence on the oil price and the poor policy environment of the past 15 years, notably 'Chávismo' or the philosophy of the late Comandante Hugo Chávez. Add to this the lack of reliable data and very poor corporate guidance, comments Murcio.

Such is the pressure on Venezuela, it has engaged in a fire sale in respect of PetroCaribe, its energy assistance programme launched by Chávez in 2005, says Murcio. Under the PetroCaribe programme, Caribbean and Central American countries paid only a portion of the bill for oil imports upfront and financed the remainder at 1% or 2% over 25 years. The Dominican Republic has repaid through a bond sale almost all of its US$4.1bn debt owed to Venezuela for years of oil shipments. Jamaica is also issuing bonds to purchase the PertroCaribe debt owed to Venezuela.

Besides the conclusion of its electoral process, among the factors weighing on Argentina are: the drop in the oil price (Argentina is looking to develop an oil sector), the increasing desire of Argentines to 'dollarise' their assets and the weaker Brazilian economy, says McDonagh. However, if Argentina (in technical default) were to normalise relations with external creditors, there are investors who would seek to invest a significant amount of capital, he says.

What to watch

- Further commodity price weakness
- The composition of the political administration in Argentina
- The impact of a US rate tightening cycle on Latin America

1. BNY Mellon Investment Management EMEA Limited is the distributor of the capabilities of its investment managers in Europe, Middle East, Africa and Latin America. Investment managers are appointed by BNY Mellon Investment Management EMEA Limited or affiliated fund operating companies to undertake portfolio management services in respect of the products and services provided by BNY Mellon Investment Management EMEA Limited or the fund operating companies. These products and services are governed by bilateral contracts entered into by BNY Mellon Investment Management EMEA Limited and its clients or by the Prospectus and associated documents related to the funds.
2.Bloomberg as at 29 October 2015
3.Source: The CIA's World Factbook

Rate This Article

Investment managers

Headquartered in Boston, Massachusetts, Standish Mellon Asset Management Company LLC (Standish) is a specialist investment manager dedicated exclusively to active fixed income and credit solutions, with a strong emphasis on fundamental credit research.

Insight Investment Global Management Limited (Insight) is a London-based asset manager specialising in investment solutions across liability driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies.

With expertise in macro analysis and bottom-up stock selection, ARX Investimentos is dedicated to investments in Brazil and Latin America. Headquartered in Rio de Janeiro, the group's philosophy is to optimise risk adjusted returns, with a focus on capital preservation.

Colm McDonagh, Insight Investment
head of emerging market debt

Javier Murcio, Standish
portfolio manager and senior analyst

Rogerio Poppe, ARX
portfolio manager