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On the Road Back from Sao Paulo: Four Observations For Outsiders from My Research Trip to Brazil

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Brazil has become one of the most followed countries in the Emerging Markets investing space – and for good reason. Its large population with multiple underpenetrated sectors, ample industrial idle capacity given the 2015-2016 recession, strong credit growth potential and a new political movement with a reformist, pro-market liberal agenda, has created strong consumer confidence and positive momentum in the country.

As an emerging markets specialist and frequent visitor to Brazil, I returned from a week-long research trip to Sao Paulo in April. There I met with my usual on-the-ground network of local political decision makers, management teams of both listed and private companies, local investors and entrepreneurs, among others. A few things struck me as worth sharing with market observers outside of the country:

Local Investors' "This Time is Different" vs. Global Investors Wait-And-See Mode

Local investors I was in touch with remain bullish on Brazil, in spite of stretched valuations, weaker than expected Q1 macro figures and early delays in the pension reform negotiations between the Government and Congress. The market rally surrounding President Bolsonaro's election in October 2018 was mainly supported by the local investment community, who sincerely believe this time is different and Brazil will meet or exceed expectations. There is a strong sense that Bolsonaro's presidency will bring much needed political change to a country that usually under-delivers vs. market expectations. "This time is different" seems to be the general view from local investors.

Many international investors, like myself, however, remain concerned about the continued momentum of the market rally based on just headlines and hardly any execution to date. The market seems to be already pricing in some degree of a positive outcome, making valuations too high for most global funds to meaningfully enter the market. International investors appear to need to see more policy execution or a meaningful correction in the market in order to think about an entry point. By contrast, local investors, who are largely overweight Brazilian risk assets, from what I observed, are hoping for a positive result and appear more willing to continue to buy Brazil at a high valuation or at any dip, as seen in this month's trading activity.

Pension Reform: a Brazilian Way of Negotiating

I was reminded about how easy it is for investors from afar to get lost in the daily Brazilian headlines, which often show strong posturing between local political opponents (both negative and positive at times). The Bovespa Index, Brazil's main equity index, has fallen c.5.5%, in local currency, from all-time highs in early March due to what many believe is disappointment with the Bolsonaro Administration's promise of public pension reform with savings of R$1.2 Trillion. In the start of a four-step process, the Justice Committee approved the reform bill in late April. However, it took four weeks longer than expected, and included a set of public pushbacks between the Committee and the Government. It is easy for many in the international investor community to miss the way negotiations happen in Brazil, where it is normal to see strong initial resistance and more passionate dialogue. Entrenched interests are naturally inclined to try to fight back after so many years of political gridlock, too. This political theater will most probably continue and keep risk assets in Brazil range bound until further progress can be seen on the pension reform issue. The next key period is likely to be sometime in June, after the bill passes through the Special Committee and is put to a vote first in the Lower House and afterwards in the Senate. Expect a late Q3 or Q4 outcome, given the way I see negotiations taking place and the Brazilian way of doing things. Considering that international investors have been sold a faster pace of reforms, the question in my mind is: "Can local investors continue to hold the market for that long, especially if poor incoming macro data is below market consensus and a global risk-off scenario may unfold with current US-China Trade disputes?"

A Tale of Two Spenders: Strong Domestic Consumers vs. Weak Industrial Momentum

It is very much apparent from speaking to management teams in Brazil that the domestic consumer is still strong, yet the latest consumer confidence indicators are starting to show some softness in the data, most probably from reform delays and weaker-than-expected macro figures. Nonetheless, private banks are extending credit to individuals and SMEs, and retailers are seeing sounds volume growth and solid pricing power. It is also apparent that corporate capex is lagging and the corporate loan books at banks are not keeping pace. Idle production capacity is still leftover from the 2015-2016 recession, dampening the need for new capex spending. This is creating an interesting dispersion between consumer-focused companies seeing resilient growth and industrial manufacturers not seeing a strong pick-up due to weak corporate demand. However, the unemployment rate is still high and slowly trending down, but not as fast as previously expected. The next leg in consumer momentum should come from a lower unemployment rate. For the corporate segment, having more stability around government finances (i.e. a meaningful pension reform approval), is likely to make long term investments more attractive and create corporate momentum in the country.

The Local Asset Management Community – Strong Increase in AUM

It was interesting for me to see the number and size of local asset managers today in Brazil. The increase in AUM, at the local level vs. a few years ago is surprising, though it helps explain the recent Brazil risk-asset rally being mainly supported by local investors and their available dry powder. Local rates in Brazil, at 6.5%, are the lowest in decades, which also appear to be fueling a rotation into equities from the local investment community. At a local bank conference I attended, of the approx. 600 investors present, only about 5% were from international firms. My impression is that it is a somewhat news flow and rumor-led local investing community, which creates momentum, crowded investing. Local flows and momentum are important factors to watch for, if investing in Brazilian public equities.

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