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What a Difference a Year Makes

What a difference a year makes: Brazil is no longer in crisis, but is not out of the woods yet

Over a year ago, Brazilian asset prices were trading at distressed levels as the country faced three macroeconomic dangers at once:

1. A potential balance of payments crisis
2. An inflation spiral and
3. A deterioration in fiscal solvency.

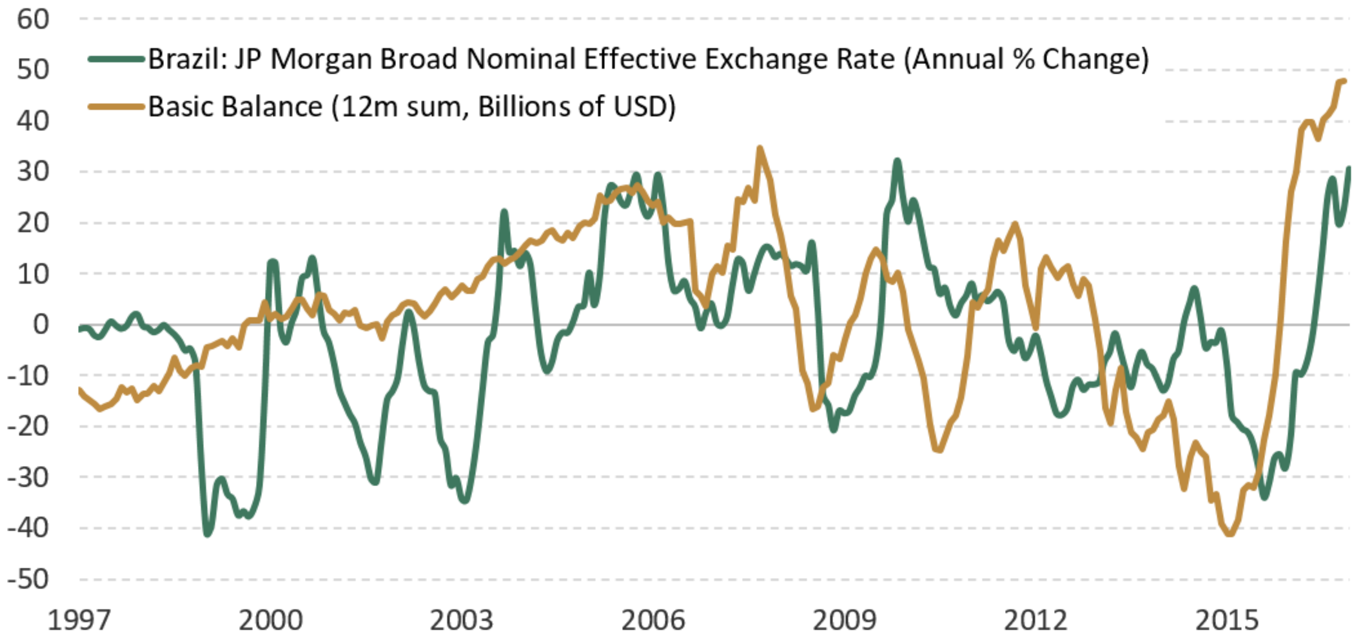
Since then, macro imbalances have largely adjusted. U.S. dollar returns for local bonds and equities have been over 60% and 120%, respectively. The question now is what to do from here by determining what risks still lay on the horizon. Let’s analyze the three macroeconomic dangers one by one.

Balance of payments improvement to support the currency

Brazil’s current account deficit has improved from a cyclical wide of -4.4% of gross domestic product (GDP) to -1.3%, or $23 billion, today. The bulk of this adjustment was the result of weaker import demand as Brazil faced a fierce recession and a weak currency which made foreign goods more expensive to purchase. Additionally, high unemployment discouraged Brazilians from traveling abroad, which contributed to an adjustment in the services balance as well. While some of this improvement should reverse as growth recovers, the current account is unlikely to trend back to the wides experienced in 2015.

Moreover, the current account is easily financed through steady foreign direct investment (FDI) inflows. The pace of FDI into Brazil has remained an impressive $70 billion a year throughout the crisis. Foreign buyers were lured in by the large domestic consumer market and attractive valuations as local firms turned into motivated sellers of wholesale businesses. If we aggregate the current account deficit and FDI, we get a measure called the basic balance, which serves as a gauge of the net flows of steady capital into a country. Brazil’s basic balance has surged (Chart 1). While the Brazilian currency is no longer as cheap as it was a year ago, it should remain supported by these steady inflows.

Chart 1: Brazil's Basic Balance Has Surged *As of 1/31/2017*

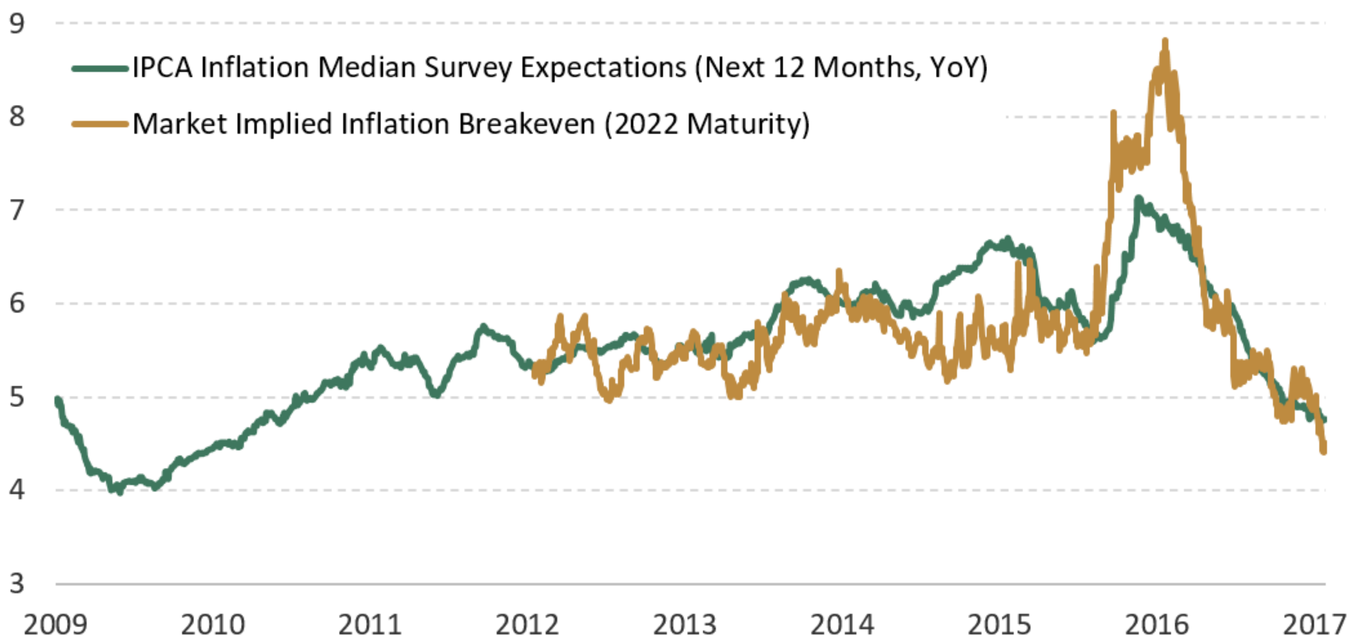


Source: Bloomberg (© 2017, Bloomberg Finance LP)

Inflation to hit new cycle lows, but might be mispriced by the market

The imbalances in inflation from a year ago have also largely corrected. Inflation for goods regulated by the government is down to 5.1% year over year (yoy) from 18.1% a year ago. Food inflation has declined from 12.8% to 8.6% and is headed lower. Even pesky services inflation, which had been somewhat sticky in 2016, has started to ease thanks in part to a weak labor market. This is all good news and should allow for substantial central bank easing. However, a lot of this is already incorporated into the price with forward-rate markets pricing in single-digit yields a year from now. Inflation expectations—as measured by the bond market as well as economist surveys—are now below 5%, the lowest in over five years (Chart 2).

Chart 2: Inflation Expections are Now Below 5% *Percent, As of 1/27/2017*



Source: Bloomberg (© 2017, Bloomberg Finance LP), J.P. Morgan

Fiscal remains the weakest link in Brazil

Of the three macro dangers Brazil faced a year ago, the fiscal backdrop remains a concern. Last year, the government pushed through constitutional amendment PEC 241, which caps government inflation-adjusted expenditures at the current level for the next 20 years—with a potential reassessment after 10 years. Congress is currently working on a pension reform that would address the long term solvency of a very generous retirement system. Together, these measures go a long way in addressing the expenditure side of the equation.

For expenditure restraint to translate into fiscal improvements, tax revenues have to recover. In 2016, tax collections experienced another strong decline; they were down -5.9% after excluding one-off payments. A gradual improvement in labor markets should eventually be followed by an uptick in income tax revenues, but further reforms on the revenue side might be necessary. As a first step, the government might consider removing some tax exemptions and raising select taxes such as the CPMF tax on financial transactions.

Reform momentum continues, but may slow as 2018 election season begins

The new government should be commended for its reform agenda. Following the impeachment of Dilma Rousseff, President Temer took office in August 2016 and appointed a number of market-friendly technocrats across several ministries and quasi-sovereign companies. Thus far, the president has been more successful than the previous administration in shepherding reforms through congress. We expect this to continue to be the case although appetite for reforms may wane as we approach the 2018 presidential elections. Meanwhile, expect corruption probes to continue to make their way through the court system; we view this as a long-term positive for Brazil although it may cause episodic spells of volatility.

Brazil is not yet out of the woods when it comes to fiscal consolidation which remains a multi-year adjustment process. The credit-risk premium in Brazil remains attractive, but is worth monitoring closely. Assuming reform implementation and some economic growth, Brazil will still take a few years to return to primary budget surpluses (Chart 3). However, the debt burden is set to remain high with general government debt to GDP at 74% relative to a median of 38% for other emerging market countries in the BBB/BB range*. In its most recent Article IV review, the International Monetary Fund (IMF) estimates that gross debt will only stabilize by 2021 at the earliest, and at levels upwards of 90% even once expenditure reforms are incorporated.

Chart 3: Brazil Primary Budget Balance *Percent of GDP, As of 1/31/2017*

Source: Bloomberg (© 2017, Bloomberg Finance LP)

Colombia, Indonesia, South Africa, Turkey, and Russia.

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