

## LATIN AMERICA

# Brazil Takes Big Reform Step

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Pension funding has been an issue in many parts of the world and has certainly been a hot topic in Brazil. President Jair Bolsonaro's election ignited market optimism on promises to reform pensions to get Brazil's fiscal house on a firmer footing. The probability of this being delivered has increased considerably after approval of a new pension reform bill in Brazil's lower Congress. Franklin Templeton Emerging Markets Equity's Gustavo Stenzel and Marcos Mundim weigh in on what the breakthrough means for the country, and for investors.

Brazil's lower house of Congress overwhelmingly approved a landmark pension reform bill this month, a positive step in a process that should substantially shore up the country's fiscal situation. While it still needs a full congressional vote, we think this is a positive development from an investor standpoint.

Brazil's official pension fund system is a mandatory, pay-as-you-go system. As the population grows older, the cost of these pensions is becoming an even bigger burden. The system also has many disparities, such as a separate, more benevolent structure for public servants.

The result has been bigger system deficits. Pensions consume around 45% of federal government budget or 9% of Brazil's gross domestic product (GDP), and the mounting costs of pensions have contributed to a surge in Brazil's public debt from around 50% of GDP in 2013 to 80% today.<sup>1</sup> Various governments in the past have tried to overhaul the system but it's a politically difficult subject, and previous administrations have failed to put in place effective reforms.

Reforming the country's pension system is President Jair Bolsonaro's top priority, and his economic team has prepared a robust and comprehensive reform bill which more aligns the retirement criteria for Brazilians with other countries. The minimum age for retirement was increased to 65 for men and 62 for women, and the minimum number of years of contribution was likewise increased, closing some loopholes.

The reform bill also removes part of the special benefits that public servants are currently entitled to. After intense negotiations in Congress in the past few months and lobbying from the most impacted working classes, Congress finally had its first successful vote on pension reform this month.

A second required vote is expected for early August, and the final vote should take place in the Senate shortly after. Savings from the reform are expected to reach 900 billion real (US\$235 billion) over the next 10 years.<sup>2</sup>

States and municipalities also have an urgent need to reform their pension systems, so if they are not included in the current reform, they will have to do so locally.

## An Improving Investment Climate

The approval of the reform should stop the escalation of Brazil's public debt and allow it to start declining in the near future. A more sustainable indebtedness level should create conditions for lower interest rates and attract private investors who may have been on the sidelines because of the political and economic instability of the last few years, which resulted in Brazil's deepest recession in history.

After the approval of the pension system reform, we expect tax reform to come next, along with privatizations and more microeconomic reforms aimed at improving Brazil's regulatory environment.

The government is already carrying out an ambitious privatization program; Bolsonaro has pledged to turn the economy toward more privatization of state-owned enterprises (SOEs), which we think should help fuel more robust job creation. We would anticipate a wave of privatizations, concessions and sale of passive stakes from government entities to come, and the reduced role of government-controlled banks should likely boost capital markets further.

Therefore, from an investment standpoint, we expect a recovery should be felt first in SOEs, along with infrastructure plays, capital markets platforms (e.g., stock exchanges), and other capital-intensive industries.

## **But Is the Good News Priced in Already?**

Brazil's stock market has anticipated part of the economic recovery as the Brazilian Ibovespa index is up 39% in the past year in local currency terms (40% in US dollar terms).<sup>3</sup> So a lot of good news is priced in already.

Yet, we remain constructive on the outlook for Brazil's market due to the previously mentioned reasons, and we believe industries with higher exposure to the domestic economy will potentially benefit from further progress.

The immediate result of pension progress should be a restoration of increased confidence in the sustainability of the public debt, and lower country risk. This environment should provide the necessary conditions for the continuation of the government's modernization agenda by attracting private-sector investment and reducing the role of public-sector investment.

While Brazil still faces some challenges, overall we have a very constructive view of the country going forward. There is high pent-up demand after years of poor economic growth and high unemployment. Inflation is low and interest rates are expected to move lower—from what is already an all-time current low of 6.5% in the benchmark Selic interest rate. We think the combination of positive factors should allow many companies' earnings to improve significantly in the coming years.

Additionally, with a lower-interest rate environment, many domestic investors will likely increasingly diversify their investment allocations away from fixed income into equities to achieve better yields. Current domestic investor allocation to equities remains near historically low levels.<sup>4</sup>

In our view, the important message is that Brazil's economy is back on track—back on a path to recovery and higher sustainable growth. We are hopeful the tide is turning in Brazil.

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[1.](#) Sources: Banco Central do Brasil, Bloomberg.

[2.](#) Source: Reuters, "Brazil Lower House Pension Reform Vote Hits Delay as Savings Cut," July 12, 2019.

[3.](#) Source: Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.

[4.](#) Source: Anbima, as of May 2019.