PERSPECTIVE

Has Brazil Bottomed?

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Last year when I visited Brazil I was cautiously optimistic, and returning again this year, I remain so. We were expecting problems, but we were encouraged to see some signs of change taking place and are hopeful that as host of the 2016 Summer Olympic Games this year, Brazil will have the opportunity to shine. People find it difficult to believe the situation will turn around in a downtrodden market like Brazil, but we have found that, in general, the time of maximum pessimism marks the time when a bottom is near, and that's the time we want to be investing.

Given all the dire headlines swirling around Brazil over the past year—including corruption scandals, ratings agency downgrades, a severe recession and the Zika virus—it may seem surprising that Brazil's stock market is actually up more than 10% year-to-date.[1] While the market seems to be reflecting some of the optimism we see, it may take some time for Brazil's economy to recover. My recent travels there confirmed the potential we see as investors in Brazil, and that opportunities still exist there.

At Carnival in Brazil

An Economic Quagmire

As my team and I took off from Buenos Aires, Argentina, for the two-hour flight to São Paulo, we wondered what the mood of the Brazilian people would be. Brazil has been mired in a terrible economic situation. Gross domestic product (GDP) sank 3.8% in 2015—the worst in 25 years—and is expected to remain negative in 2016. The Central Bank of Brazil's key short-term interest rate, the Selic rate, is above 14%, inflation has been running above 10% and the unemployment rate was about 7%–8% at the end of 2015.[2] Brazil's currency (the real) has devalued significantly against the US dollar, and gross government debt as a percentage of GDP has risen above 60%.[3]

In the wake of a credit rating agency downgrades to below investment-grade status by two of the three major credit agencies, in September of last year the government proposed an austerity plan that included spending cuts and tax increases totaling about US$17 billion.[4] The plan included cuts in tax incentives granted to the chemicals industry and manufactured exports, elimination of 10 government ministries from the current 37, a freeze on public employee salaries, a reduction in health care and low-income housing budgets, a new tax on financial transactions and an increase in the capital gains tax, from 15% to 30%. However, given the weak political position of President Dilma Rousseff, it was questionable whether the National Congress would support the proposed fiscal retrenchment. With her approval rating in opinion polls at a mere 7%, Rousseff probably figured she didn't have much to lose if the measures were unpopular. Even Vice President Michel Temer opposed the financial transactions tax.

Nevertheless, commentators said that even if the measures were passed, a further downgrade probably could not be avoided, and that's exactly what happened. In February 2016, Moody's was the last of the big three rating agencies to downgrade Brazilian debt to junk status. In its decision, Moody's cited the combination of a low-growth environment, the likelihood that the government's debt would exceed 80% of GDP within three years—annual interest payments account for more than 20% of government revenues—and the challenging political environment complicating the government's ability to pass fiscal reforms.[5]

It is important to note that in late 2015, the Tribunal de Contas da União (TCU), Brazil's federal audit court upholding the Fiscal Responsibility Law,[6] voted to reject the government's 2014 fiscal accounts, the first time this had been done since 1937. The TCU said Rousseff had manipulated the fiscal accounts in the run-up to the presidential election (making the accounts appear more attractive than they really were) with irregularities totaling about US$26 billion. Government expenditures were much higher than the government reported at the time, which led to a damaging fiscal situation creating high inflation and a deep recession. This led for calls for the impeachment of Rousseff, but a Supreme Court injunction in favor of Rousseff reduced this risk. Demonstrations that spread throughout Brazil this month were the biggest in history, with widespread support for the ongoing crackdown on corruption cases. The pressure has increased on the president and her position seems to have weakened further. While demonstrators continue to clamor for her removal or resignation, in my view, reform is what's really needed in many areas, including labor, taxes and the retirement system, even if she remains in charge.

Austerity measures in Brazil have had an impact on many sectors of the economy. A Brazilian airplane manufacturer we visited reported that the government's austerity measures have forced it to delay the first deliveries of its much-anticipated cargo jets until the first half of 2018 from an original deadline of end-2016. The delays will affect not only the Brazilian company and other countries it has contracted with to deliver planes, but also the suppliers of the parts that they import from all over the world, particularly the United States.

Exports a Bright Spot

One bright spot for Brazil last year was a trade surplus. Due to lower imports and better-than-expected exports because of the weak currency, we think Brazil could maintain a good trade position but that remains to be seen. For example, automobile exports were up 37% in January 2016 on a year-over-year basis.[7] As far as the domestic market is concerned, however, Brazil's numbers for various industries have told a more depressing story. Retail sales, sales of automobiles and other durable goods, and industrial production have dropped and are not expected to see much, if any, improvement in the near term. Consumers' purchasing power has been weakened by high inflation, while unemployment is hurting household income. Tax increases on a wide range of products, including cigarettes, chocolate and ice cream, haven't helped consumer confidence, and companies have been delaying capital expenditures.

Brazil has been in a difficult position due to a combination of government economic policy mismanagement, a major corruption scandal and very low commodity prices (Brazil's is a major exporter of iron ore and other minerals as well as oil). Since banks have been launching stricter credit controls, credit is not flowing and consumer credit is weak since households are cutting back on borrowing. In addition, a number of companies face financial stress because their US-dollar debts have now increased dramatically in local currency terms as a result of the real's devaluation of more than 80% since the middle of 2014. We visited a shopping-mall operator in Brazil which seemed to have a booming clientele, but was having problems making payments on its debt. It was a classic case of currency mismatch, since the company's revenues were in local currency but two-thirds of its debt was in US dollars.

The weaker currency hasn't been bad news for all industries—as noted, it has been beneficial for some export-oriented companies. One of Brazil's major food manufacturers we visited reported that the weaker real was an advantage, as half its sales were in foreign markets. It is in the process of restructuring in its foreign operations, including a new organization in its African markets and expansion in the Middle East, with new processing plants as well as expansion plans in China and other parts of Asia. We were also interested to learn the company was focusing more on mergers and acquisitions. There's no question to us that many Brazilian companies have very capable managers, and if there is a change in the government's attitude toward reform and it adopts a more pro-business model, we think that would be very positive.

Even when economic conditions seem dire, there are opportunities for investors willing to look for them. Brazil has great export potential in manufacturing and agriculture, and we think that should start to be reflected in better GDP figures going forward. Additionally, we have been encouraged to see more concrete action to tackle corruption in Brazil, including the investigation of political figures. Although recent scandals have taken a toll on the economy, I think the transparency we've seen in going after corruption is resulting in faster corrective action, which fuels my optimism that Brazil may be on the brink of positive change. I am confident reforms will take place in Brazil, although they won't happen overnight. Investors in such situations have to learn to be patient.

In my next blog, I'll expound upon more companies we visited in Brazil, how they have been tackling challenges, and whether we found good investment prospects.

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1. Source: Bovespa Index (Ibovespa), year-to-date through March 7, 2016. The Bovespa Index is designed to gauge the stock market's average performance, tracking changes in the prices of the more actively traded and better representative stocks of the Brazilian stock market. Indexes are unmanaged, and one cannot directly invest in an index. They do not reflect any fees, expenses or sales charges. Past performance is no guarantee of future results.

2. Sources: Bloomberg, Brazil Central Bank (Banco Central do Brasil).

3. Ibid.

4. Source: Reuters, "Brazil Announces $17 Billion in New Taxes, Spending Cuts," September 14, 2015.

5. Source: Moody's Investors Service, February 28, 2016.

6. Brazil's Fiscal Responsibility Law was enacted in 2000 and established a broad framework of fiscal planning, execution and transparency at the federal, state and municipal levels.

7. Source: National Association of Motor Vehicle Manufacturers, Brazil.