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Cautious optimism on Brazil

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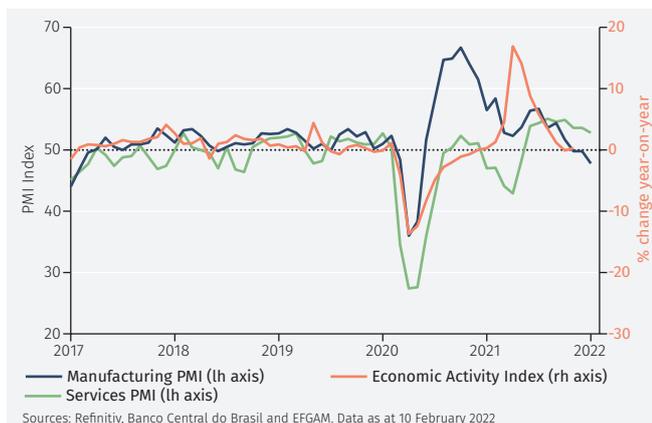
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CAUTIOUS OPTIMISM ON BRAZIL

The Brazilian economy entered a recession in the third quarter of 2021 after two consecutive quarters of negative growth. The IMF and Brazil's Ministry of Finance differ over their outlook for the economy in 2022. In this issue of *Infocus*, Joaquin Thul analyses the economic context and explains why we should remain cautiously optimistic on Brazil.

Activity indicators in Brazil such as the Economic Activity Index produced by the Brazilian Central Bank (BCB) and the manufacturing PMI index have fallen since the end of the third quarter of 2021, reflecting a decline in economic activity. The services sector has been more resilient, following an improvement in demand, although the growth pace has slowed since the start of Q4 2021 (see Figure 1).

1. Economic activity slowing down in Brazil



The IMF forecasts GDP growth to slow to 0.3% in 2022 from over 5% in 2021. Government projections are more optimistic and see growth above 2% this year. This difference created a controversy between the Ministry of Finance and IMF authorities over the strength of Latin America's largest economy, which culminated in the decision by the IMF to close its representative office in Brazil by June 2022.

The IMF view

There are two main reasons for the IMF's view that the economy will be weaker than the government expects. First, the negative impact on domestic demand from the monetary tightening implemented by the BCB. Over the last twelve months it has increased the Selic rate eight times, from 2% to 10.75% to fight the rise in inflation, which spiked from 5% to over 10% in that period. Second, reduced fiscal support will contribute to the deceleration in growth. The government has started to reduce its deficit from the levels of the last two years when the fiscal rule was suspended. The primary deficit rose

to 9.2% of GDP in 2020 and the IMF expects it will have already declined to 1.6% in 2021 and will fall further to just 0.8% in 2022.

The optimistic scenario

Brazilian authorities anticipate a more optimistic scenario. In particular, their projections assume a more favourable external environment. The economic recovery in the United States, China and the eurozone, which account for 55% of the country's exports, will contribute to a pick-up in external demand; and higher commodity prices, particularly for oil, soybeans and metals (notably iron ore, aluminium and copper) will further boost export receipts.

Minister of Finance Paulo Guedes also expects over USD 155 billion in investment, approximately 10% of GDP, and an improvement in the labour market due to a rapid reopening of the economy given high Covid-19 vaccination rates.

Government officials assume the recent success at controlling the spread of the virus will support stronger economic growth. The appointment of Marcelo Queiroga as the fourth Health Minister in two years has been a key factor in this.¹ Following his guidance, Brazil secured enough vaccine supply and started domestically producing the AstraZeneca vaccine. Currently over 80% of the population have had at least one dose.

What to expect from Brazil in 2022

Aside from the disagreement between Guedes and the IMF, there are important points to highlight when considering the outlook for Brazil.

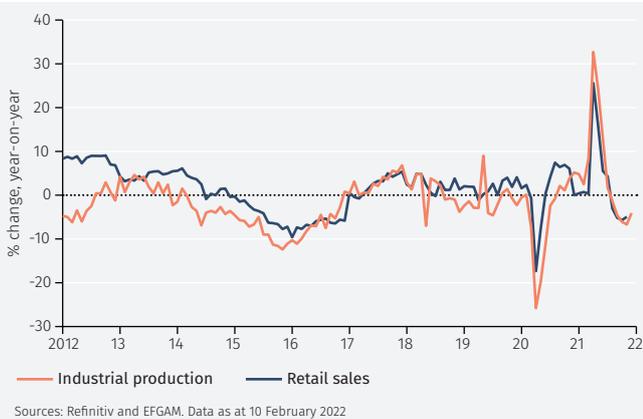
The recovery in activity is still too early to call. Recent data for industrial production shows a short-term pick-up in activity, driven by production of durable goods, although it remains down by 4% on a year-on-year basis (see Figure 2a). Additionally, although the unemployment rate has declined from the peak observed in September 2020, it remains high – at almost 12%, and still above pre-pandemic levels. The Composite PMI subindex tracking job market conditions shows employment continues to rise in the service sector, but it remains under pressure in manufacturing areas (see Figure 2b).

¹ Since January 2020 Brazil has had four Health Ministers. Luiz Henrique Mandetta and Nelson Teich, were replaced due to disagreements with President Bolsonaro over strategies to control the virus. Eduardo Pazuello, an army general with no prior experience of health policy, supported the President's use of anti-malaria drugs to treat Covid patients. He was replaced after Covid-related deaths reached a critical level in March 2021, representing over 20% of the world's total. Marcelo Queiroga, appointed in late March, is the current Health Minister.

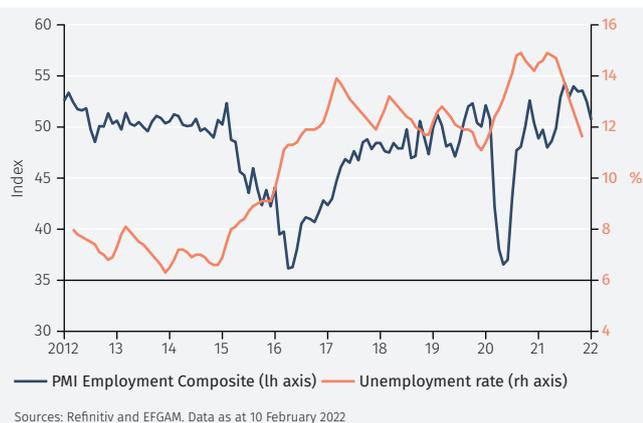
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2. Weakness in economic indicators threaten a quick recovery

2a. Industrial production



2b. Labour market



Therefore, despite the recent upbeat data, activity in Brazil is likely to remain under pressure in the first half of the year due to weakness in consumer demand and industrial production. Demand will continue to be subdued by inflationary pressures (which have yet to respond to the BCB's tightening) and a labour market that has been slow to recover.

The second point to consider relates to the political environment. The general elections scheduled for October 2022 could drive market sentiment in Brazil this year. The incumbent President Bolsonaro and former President Lula Da Silva are expected to be the frontline candidates. The former joined the Liberal party in November 2021 to try to gather support from centre voters, while the latter will run again as the Worker's Party (PT) candidate after being cleared from corruption allegations.

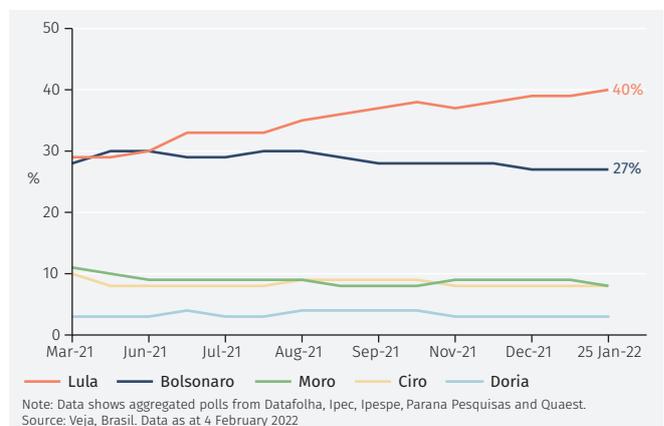
Possible political scenarios

Bolsonaro's government was successful at passing the pension system reform in the first year of its term. Plans to reform the public sector and the tax system were delayed by the loss of political support for the President in Congress and due to the pandemic. If Bolsonaro is re-elected, it would be reasonable to expect renewed efforts to pass these reforms, assuming a continuation of the current economics team.

The outcome of a potential victory for Lula is slightly more uncertain as no plans or teams have been announced yet. During his previous two terms as President, from 2003 to 2010, Lula's governments were focused on strengthening social programs but were characterised by orthodox economic policies. However, progress on reforms was poor and he was criticized for his moderation by parts of the PT.

A Lula victory, currently reflected in the polls, is generally seen as positive by foreign investors. According to aggregated poll data from Veja, Lula leads voting intentions with 40% support, against 27% for Bolsonaro. The gap between the two candidates has widened since Q3 2021, coinciding with the worsening of economic data (see Figure 3).

3. Brazil General Election: Aggregated first round voting intentions



Despite the uncertainty over the election outcome, inflows into Brazilian equities have hit a record of USD 13 billion in the first two months of the year, driven by foreign investors who currently own 53% of the Brazilian market. Valuations have played a key role, reflected in the relative cheapness of Brazilian equities over the last three years in our valuation model (see Figure 4). The rise in commodity prices, which helps domestic stocks, and the potential end to the rate hiking cycle also contributed to the attractiveness of Brazilian stocks. After a

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4. Valuation model of Brazilian stocks



Foreign investors have overlooked these issues and inflows into the domestic equity market have hit historical highs, benefiting from attractive valuations. Overall, we remain cautiously optimistic on Brazil in 2022. The improvement in the external context and the backdrop of higher commodity prices could be a catalyst for stronger growth. However, in the short-term, it is likely the economic situation will get worse before it gets any better as low PMI Indices and high inflation point to a weak economic performance during the first half of the year.

disappointing 2021, the Brazil stock index is up 7.3% year-to-date, being one of the best performing equity markets in 2022.

Conclusion

Brazilian authorities and the IMF disagree over the strength of the Brazilian economy in 2022. The amount of monetary tightening by the BCB and the reduction in fiscal support will weigh on GDP growth. Activity indicators have slowed, particularly in the manufacturing sector, while unemployment remains high. However, the reopening of the economy and the improvement in some of Brazil's main trading partners will help to boost activity and exports. The general election will add an extra layer of uncertainty to the outlook, given the differences between candidates.

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