



# Brazil: Mid-Year Economic and Political Update

The outlook for Brazil currently is clouded by several issues, but greater clarity is expected in the coming months. The country recently emerged from a crippling truckers' strike only to face new economic challenges from rising oil prices and the U.S. dollar. Political uncertainty is expected to subside following the upcoming general election, allowing the focus to shift to much needed pension reforms.

## PRESIDENTIAL ELECTIONS

With the recent conclusion of party conventions and the formal announcements of candidates and coalitions, the pace of campaigning will start to accelerate ahead of Brazil's October presidential elections (see [Figure 1](#)). New election campaign reforms will be implemented for the first time, including bans on corporate donations. These changes will significantly reduce the amount of available campaign funds. Candidates must now split a pool of funds based on the size of their party or coalition, which is why the coalition announcements were so important.

The Brazilian Social Democracy Party (PSDB), with Geraldo Alckmin running as president, formed the largest coalition (8 parties) and garnered the biggest prorated shares of TV time (45% of total time) and election funds (47% of total funds). The Workers' Party (PT) formed the second-largest coalition with Luiz Inacio Lula da Silva and Fernando Haddad named as presidential and vice presidential candidates, respectively. However, it is unlikely that the courts will allow jailed former President Lula to run for reelection. While Haddad will likely become the PT's presidential candidate, Lula is still polling around 30%, which may enable the party to transfer significant votes to its candidate of choice.

The uncertainty around the election and Lula's candidacy has led to an increased number of undecided or null voters in opinion polls. According to a recent Bloomberg article, 8 out of 10 women voters are undecided or intend to cast a void ballot. Since women voters are expected to be key to this election, some candidates have selected female vice presidential running mates. There is some debate as to where these undecided voters will go. Some of the more controversial candidates, such as Jair Bolsonaro, have turned to social media to attract voters and offset limited TV time slots. However, while social media has become more relevant compared to past elections, it will not be as effective as TV and radio given low smartphone/data penetration rates versus the availability of TV in 97% of households. Since the outcome of the election will be pivotal to several important issues facing Brazil, particularly pension reforms, we will be closely monitoring the opinion polls and trends in the undecided and null categories along with the coalitions and candidates.

**Figure 1** Brazil's 2018 Election Timeline

DATE	DEVELOPMENT
15 August	Deadline for candidates' registration
16 August	Election campaign begins
31 August - 4 October	TV and radio election advertising allowed
6 October	Campaign ends
7 October	First round election
8-26 October	Campaign for second round of elections
28 October	Second round election
1 January	New president sworn in

Source: Bloomberg (© 2018, Bloomberg Finance LP)

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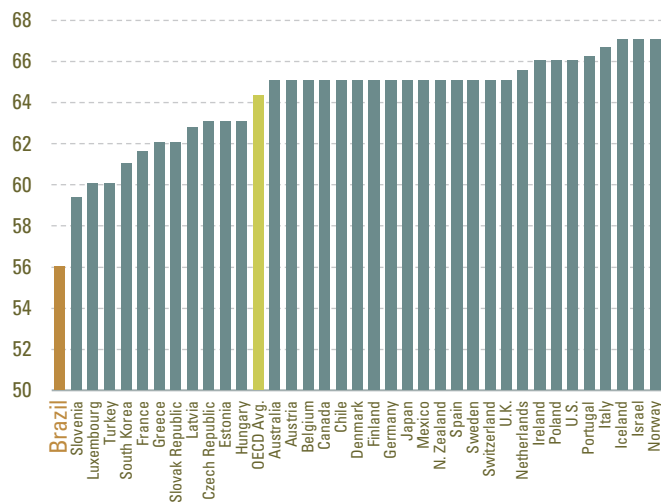
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## PENSION REFORMS

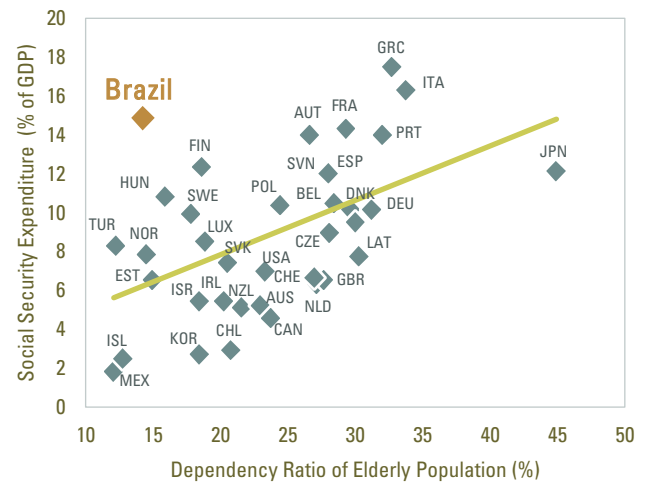
As soon as the presidential elections are over, we expect markets will immediately shift their focus to the pension reforms that are required from a debt sustainability standpoint. Brazil is currently running a budget deficit of around 9% of gross domestic product (GDP) with gross debt-to-GDP at 75%. Pension spending represents nearly half of total spending. Although Brazil is a demographically young country, its retirement age is low (see **Figure 2**) and its pension payouts are quite generous. Additionally, countries with higher dependency ratios—which measure the percentage of the population over 65 years of age relative to the working age population—have older populations and typically spend more on social security payouts (see **Figure 3**). Brazil has a dependency ratio of a young country but spends on social security like an aging country. By 2030, social security spending will be upwards of 25% of GDP under current trends, deteriorating Brazil’s fiscal balance and putting a severe strain on its debt sustainability. While a vote on pension reforms was canceled recently, most politicians appear to understand the need for an overhaul, according to conversations we have had with various political analysts. The outstanding questions include the depth of pension reforms and uncertainty surrounding the election outcome. See our recent blog “[Brazil’s Pension Problem Is No Longer Tomorrow’s Problem](#)” for more on this topic.

**Figure 2** Current Average Retirement Ages by Country  
 For a person that entered the labor force at age 20, men, As of 12/31/2016



Source: OECD

**Figure 3** Dependency Ratio and Social Security Expenditure  
 %, As of 12/31/2016

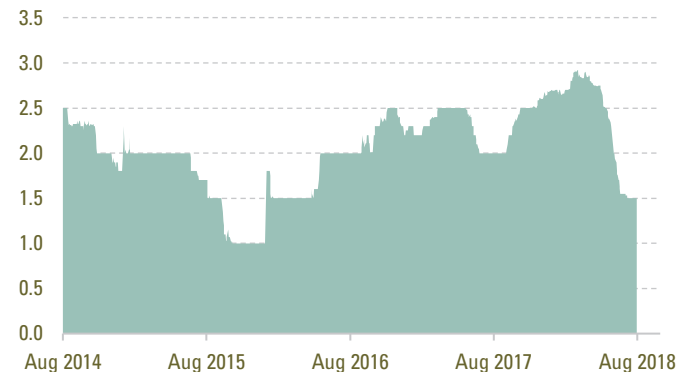


Source: OECD, Macrobond

## ECONOMY

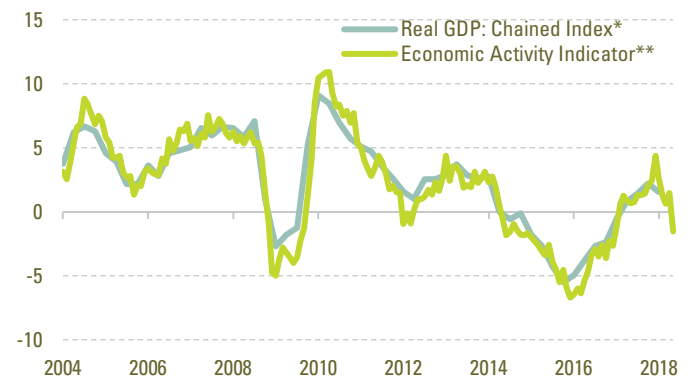
Year-end growth expectations fell sharply in late March, dropping from 3% to 1.5% (see **Figure 4**). The economic activity indicator dropped due to the now resolved truckers’ strike (see **Figure 5**). We will be watching the activity indicator closely to see how quickly the economy can recover.

**Figure 4** Brazil GDP Growth Expectations  
 Last Price, As of 8/3/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

**Figure 5** Brazil GDP & Economic Activity  
 %, As of 5/31/2018



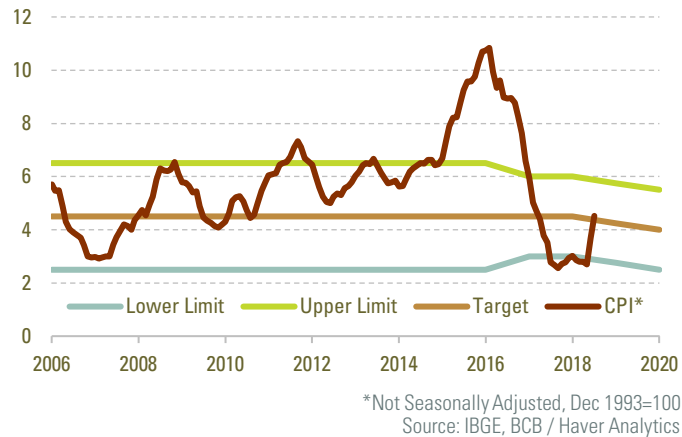
\*Seasonally Adjusted, 1995=100 \*\*Seasonally Adjusted, 2002=100  
 Source: IBGE, BCB / Haver Analytics

### CENTRAL BANK

The Brazilian central bank is likely to hold its Selic lending rate at or around the current levels. Inflation spiked following the truckers' strike (see **Figure 6**) in late May and into June across many products, but expectations remain below the mid-point of the central bank's inflation target range (see **Figure 7**). Slack in the economy remains with high unemployment rates around 13%, low capacity utilization rates, and a slow recovery in growth. In the central bank's latest FOCUS survey, market participants are forecasting inflation of 4.10%.

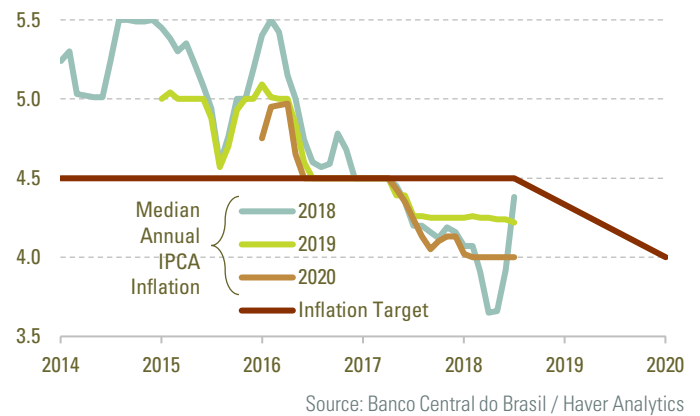
**Figure 6 Inflation**

% YoY, As of 7/31/2018



**Figure 7 IPCA Inflation Forecasts**

%, As of 7/31/2018

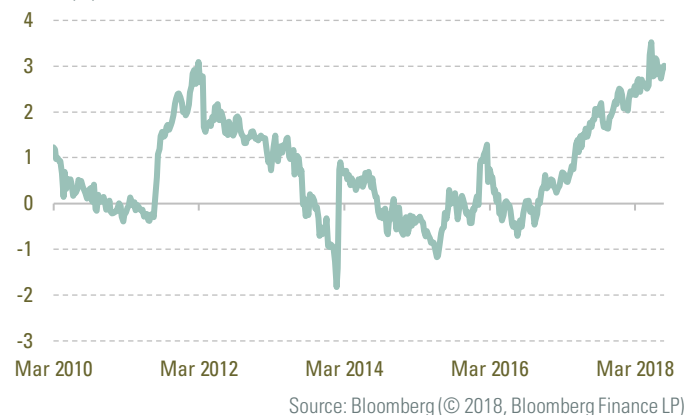


### BOND MARKET

We believe the local bond market is attractive. Real yields remain elevated at 7% and, as discussed above, we believe inflation should stay within the central bank's target range. The yield curve as denoted by the 2-year and 10-year differential is currently around 300 basis points, one of the widest spreads in the past 10 years and currently the steepest curve in our emerging market universe (see **Figure 8**). With Brazil's economy still experiencing a sizable output gap, front-end rates should remain well anchored, in our view. Furthermore, if meaningful pension reform is passed, we would expect real and nominal rates in Brazil to compress.

**Figure 8 2-Year and 10-Year Yield Curve Spreads**

As of 8/3/2018



### SUMMARY

Prior to the truckers' strike, Brazil had been making strides toward political and economic advancement, including drawing very close to passing needed reforms. We will be following the upcoming election closely as its outcome likely will have a major impact on future progress. We continue to see attractive opportunities in Brazil given the presence of high real yields, the potential for continued economic expansion, and relatively low inflation that is well within the bounds set by the central bank.

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