

The Brazil Dilemma

Brazilian financial markets currently represent a classic dilemma often seen in the developing world. On one hand, the bond market has sold off sharply since 2013, driving yields to very attractive levels. On the other hand, its interest rates also reflect heightened currency risk. A key investment issue today is whether bondholders are being adequately compensated for both currency and interest-rate risks.

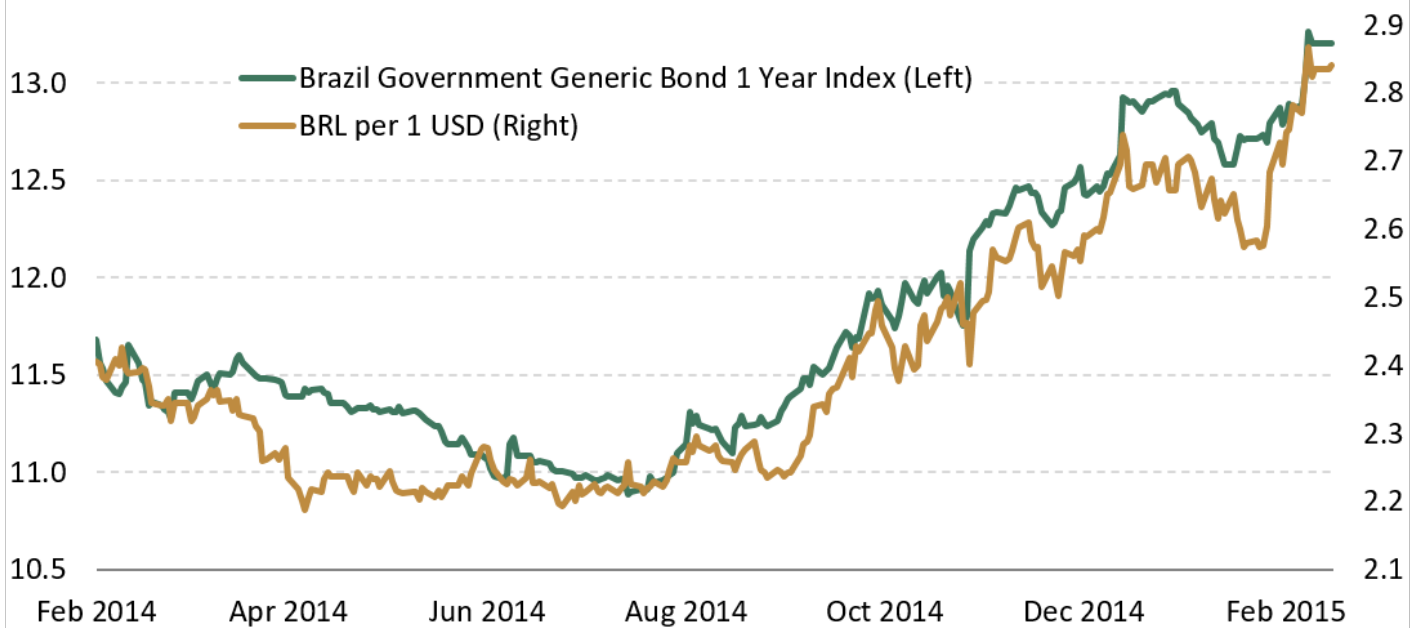
The Bond Market: What Has Been Priced In?

Brazilian yields have fully discounted the ongoing recession in the economy. The 10-2 year curve is inverted, with a half point negative spread. Curve inversion often happens whenever there is a recession in Brazil. For instance, the 10-2 curve inverted in 2008—briefly in 2011, 2012, and 2013—and once again after 2014.

In all of these cases, the economy was either in deep contraction (e.g. 2009) or a mild recession (e.g. 2011). The level of the current curve inversion suggests the Brazilian economy either is or will go through a 1-2% economic contraction.

As shown in [Chart 1](#) below, bond market selloffs usually happen in tandem with a falling real, and this time is no different. The obvious link here is inflation: a falling real increases inflation expectations and thus drives up bond yields.

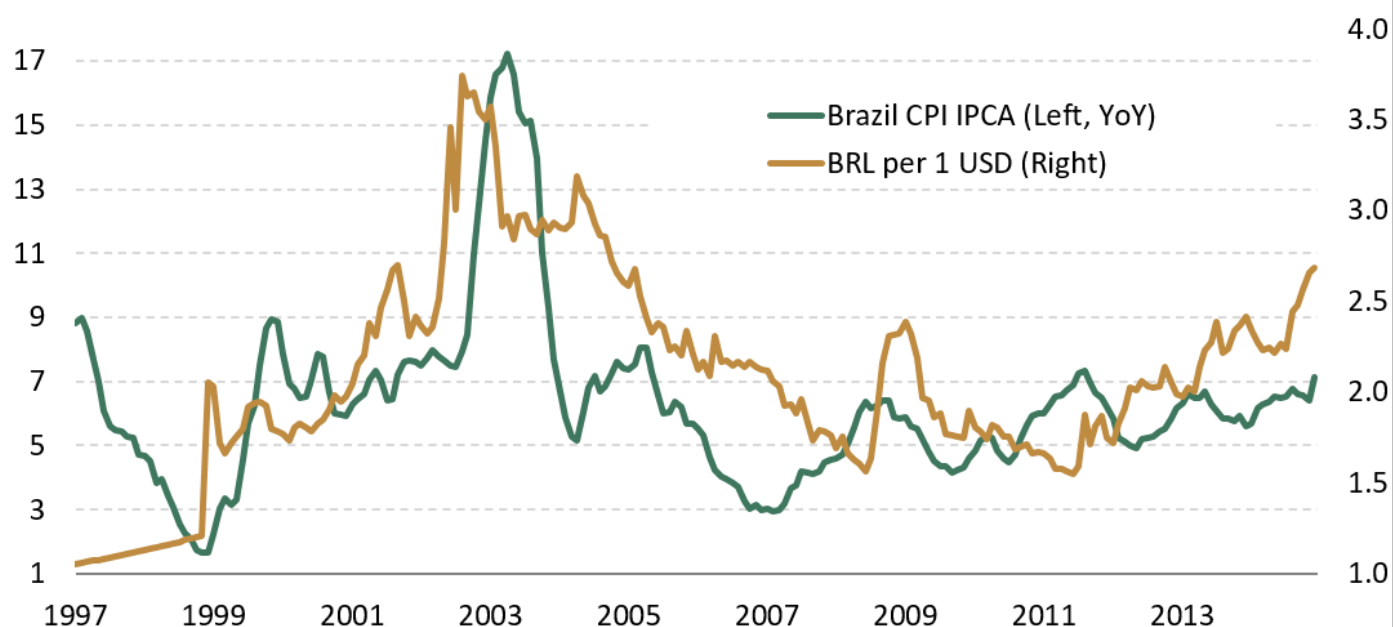
Chart 1: Brazil Government Generic Bond 1 Year Index vs. USD/BRL As of 2/18/2015



Source: Bloomberg (© 2015, Bloomberg Finance LP)

The question is whether the bond market has fully priced in the expected rise in inflation. At present, inflation is running at a 7% pace, which is high by global standards but only slightly above Brazil's own historical average. It is certainly possible that inflation will continue to creep up due to the lag created by the falling currency. According to [Chart 2](#), Brazil's inflation rate does not yet reflect the magnitude of the real's depreciation since 2013. A simple regression suggests that Brazil's inflation rate will climb to around 10% mid-year.

Chart 2: Brazil CPI IPCA vs. USD/BRL As of 1/30/2015



Source: Bloomberg (© 2015, Bloomberg Finance LP)

However, with yields at 12.8%, the bond market has more than discounted Brazil's nominal outlook. Here's why: assuming the inflation rate indeed spikes to 10% by mid-2015, current bond yields would represent a real bond yield of about 3%.

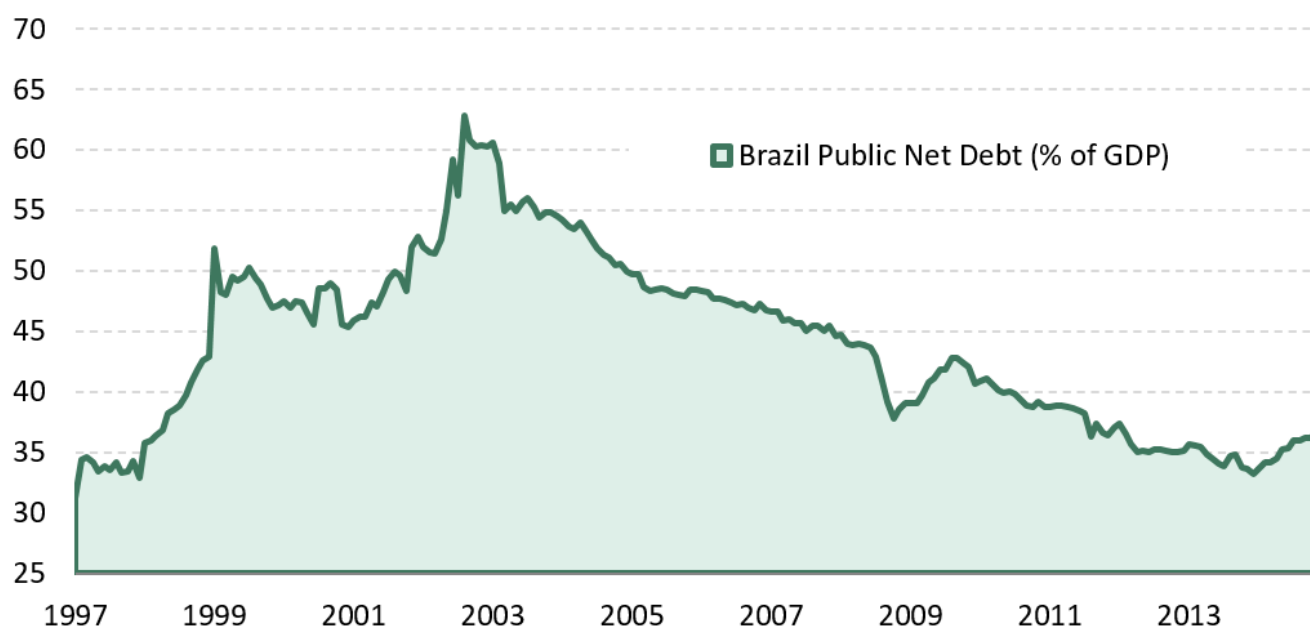
In fact, Brazil's real gross domestic product (GDP) growth has averaged about 2.5% since 2002, so the real yield is in line with real growth. Of course, one could argue that current bond yields are already too high given that Brazil's economy has been in recession since 2014, or that the country's inflation rate is unlikely to reach 10%. If so, the bond market is deeply undervalued.

Some Positives for Bonds

Major forces suggest that bond yields may not rise much beyond their current levels:

- A credible central bank, which has largely maintained financial and price stability since the 1998 debacle. With a series of rate hikes since 2013, narrow money growth has slowed, suggesting a slowdown in nominal growth in the months ahead.
- The public sector debt level stands at 36% of GDP, which is significantly lower than its peak during the 1998 crisis (see Chart 3). Brazil is far from maxing out its borrowing capacity.

Chart 3: Public Net Debt As of 12/31/2014



Source: Bloomberg (© 2015, Bloomberg Finance LP)

- Real wages have been falling for more than three years. There is not much excess demand to sustain a continued rise in inflation.
- Brazil has accumulated about \$360 billion in official reserves, which covers more than 18 months of imports. Should currency depreciation spiral out of control, the central bank has the resources to intervene in the market and stabilize the exchange rate.
- Stuningly, Brazil's import-price inflation has turned negative despite the fall in currency. If this is not a statistical error, the implication is that "follow through" inflation from the real's recent drop will be very limited.

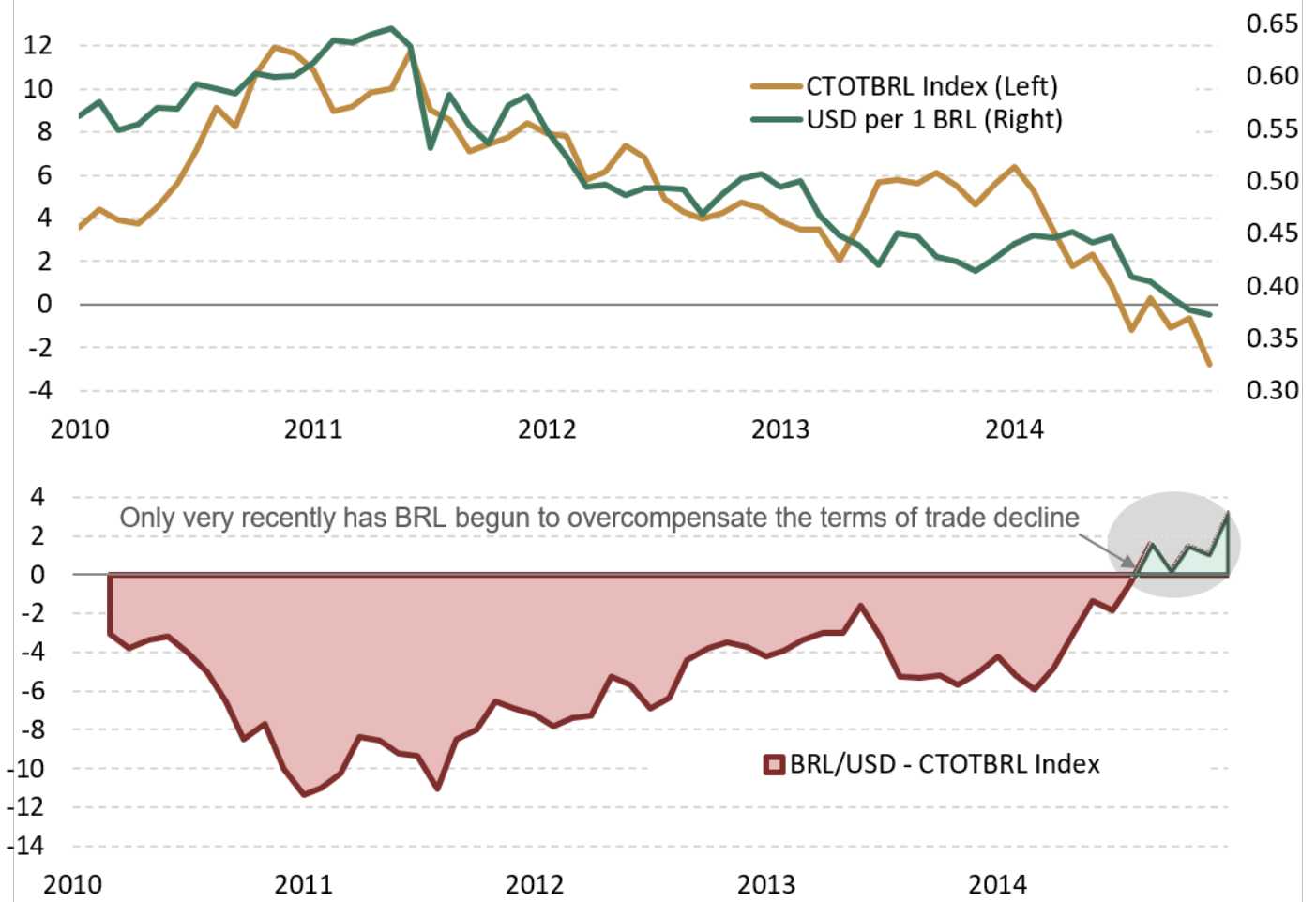
The bottom line is that Brazilian bonds could be undervalued and may have limited downside price risk. While the positive factors outlined above support lower yields, there are still some potential trouble spots that could spook the bond market and cause yields to rise even more. Therefore, yields may not melt immediately as Brazilian bonds remain vulnerable to certain deficit-related issues.

Vulnerable Spots

There are two vulnerable spots. The first is the current account deficit. It is rather disturbing that with a near 50% fall in the real since 2011, Brazil's current account deficit remains large and currently stands at 4% of GDP. This is very different from India or Indonesia, where currency declines since 2013 have already led to notable improvement in international balance-of-payment conditions in both countries. This is not the case for Brazil.

The reason for Brazil's slow improvement in its external account has much to do with the country's negative terms-of-trade shock. Chart 4 shows that although the real has fallen precipitously since 2011, the currency has mostly mirrored the decline in Brazil's terms-of-trade for the same period. Only very recently has the drop in the real begun to "overcompensate" the terms-of-trade decline for Brazil.

Chart 4: BRL/USD vs. Terms of Trade As of 1/30/2015



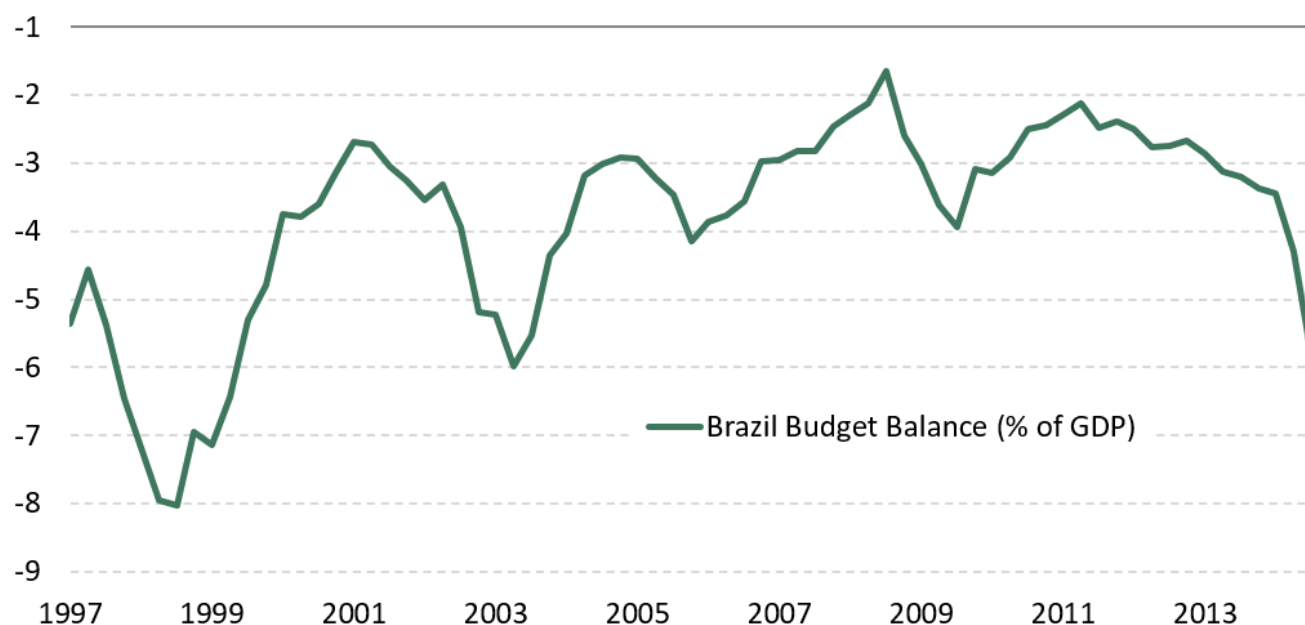
Source: Bloomberg (© 2015, Bloomberg Finance LP), Citi Terms of Trade Index

This “overcompensation” would mean the much-cheapened real will soon begin to help narrow Brazil’s current account imbalance. Time will tell. Nevertheless, if commodity prices continue to drop, additional declines in the real would be both necessary and inevitable.

Another key vulnerable spot is Brazil’s fiscal condition. Currently, Brazil’s budget deficit is close to 6% of GDP (see Chart 5 below). The only time public finances were in significantly worse shape was in 1998, when the country was going through a major currency collapse and economic crisis.

President Dilma Rousseff’s government is clearly responsible for the significant deterioration in Brazil’s fiscal health, but the bond market selloff suggests that government policy has run into a brick wall: Rousseff must change course or the country will eventually head for fiscal ruin. Of course, the commodity market selloff has not helped either.

Chart 5: Brazil Budget Balance As of 12/31/2014



Source: Bloomberg (© 2015, Bloomberg Finance LP)

The scandal surrounding Petrobras has put the government in the spotlight again. Investors are clearly questioning the financial viability of a state-owned energy company. The Brazilian government has the resources to keep Petrobras afloat but a substantial injection of funds is inevitable, given how massively indebted the company has become.

Overall Assessments

Domestic bonds should have limited scope for large additional price weakness, given subdued inflation, weakening money growth, and softening import-price inflation. Nevertheless, the currency market remains unsettling.

Although the real is fairly valued after its recent fall, it is not deeply undervalued. In real effective exchange rate terms, the Brazilian real remains expensive. In addition, there are a host of conditions that are beyond the control of the Brazilian authorities, such as risk perception, the U.S. dollar trend, and the currency is still being held hostage by global commodity prices.

Nevertheless, we do not expect a currency crisis will occur, and Brazil's sovereign risk is well under control, with limited foreign currency debt. Therefore, any selloff relating to sovereign risk may have been driven by fear, and therefore may represent a mispricing.

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