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Brazil’s Pension Problem is No Longer "Tomorrow’s Problem"

Emerging markets performed poorly in 2Q, but the weakness in Brazilian assets stands out. The currency was the second weakest in emerging markets during the second quarter, after Argentina. Unlike its Argentine neighbor, Brazil runs a small current account deficit, easily financed by foreign direct investment (FDI), and the central bank has $380bn to lean on during short-term volatility. Inflation remains under control with 12-month median inflation expectations at 3.8%— well below target. So what is price action telling us about the future outlook?

We think there are three issues of concern for the market:

1. The trade war is weighing on the prices of key Brazilian exports such as soybeans,
2. Growth estimates are being revised lower after a truckers’ strike that paralyzed the country, and
3. Pension reform is no longer “tomorrow’s problem.”

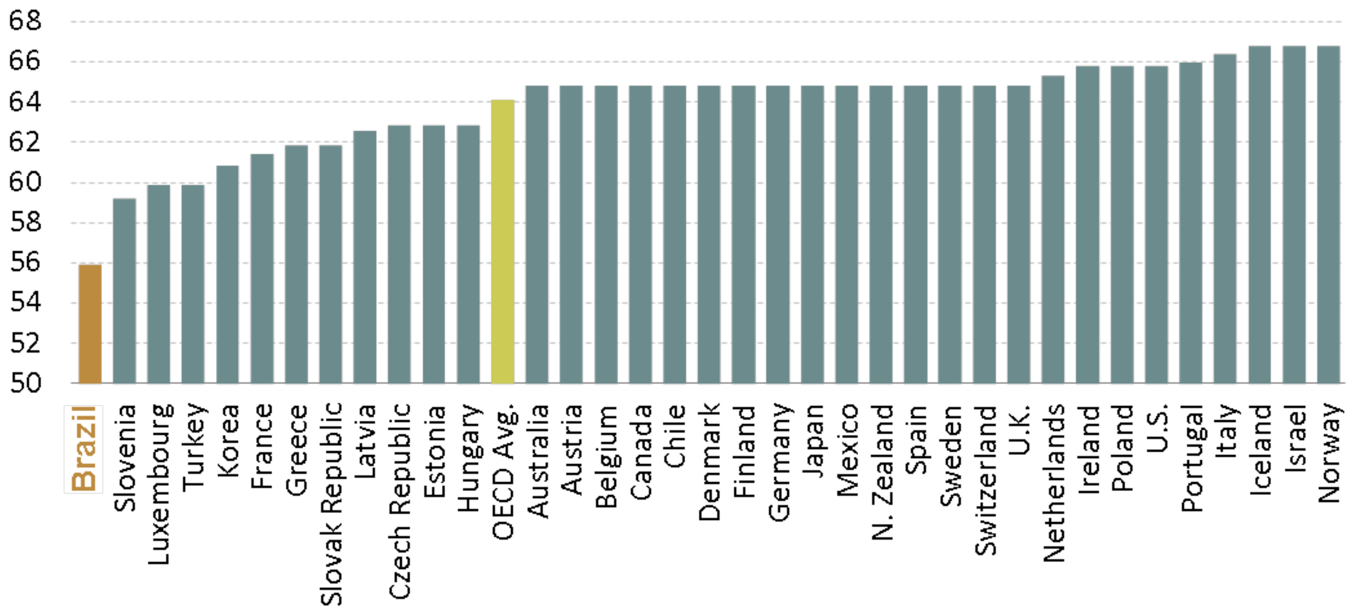
Of the three, we could make an argument that the first two are material, but transient. However, we remain concerned about the pension issue. It also happens to be a presidential election year with no clear front-runner which introduces an extra element of uncertainty.

The Pension Issue is No Longer “Tomorrow’s Problem”

Let’s start by putting the pension problem in perspective. Brazil is already running a budget deficit of 9% of gross domestic product (GDP) with gross debt-to-GDP at 75%. Pension spending already represents nearly half of total spending. Although Brazil is a relatively young country, its retirement age is low (see Chart 1) and its pension payouts are quite generous. We show this in a chart by looking at the dependency ratio which is a measure of the percentage of the population over 65 years of age relative to the working age population. Countries with higher ratios have older populations and thus, spend more on social security payouts. Brazil, however has a dependency ratio of a young country, but spends on social security like an old country (see Chart 2). By 2030, social security spending will be upwards of 25% of GDP under current trends.

Chart 1: Current Average Retirement Ages by Country

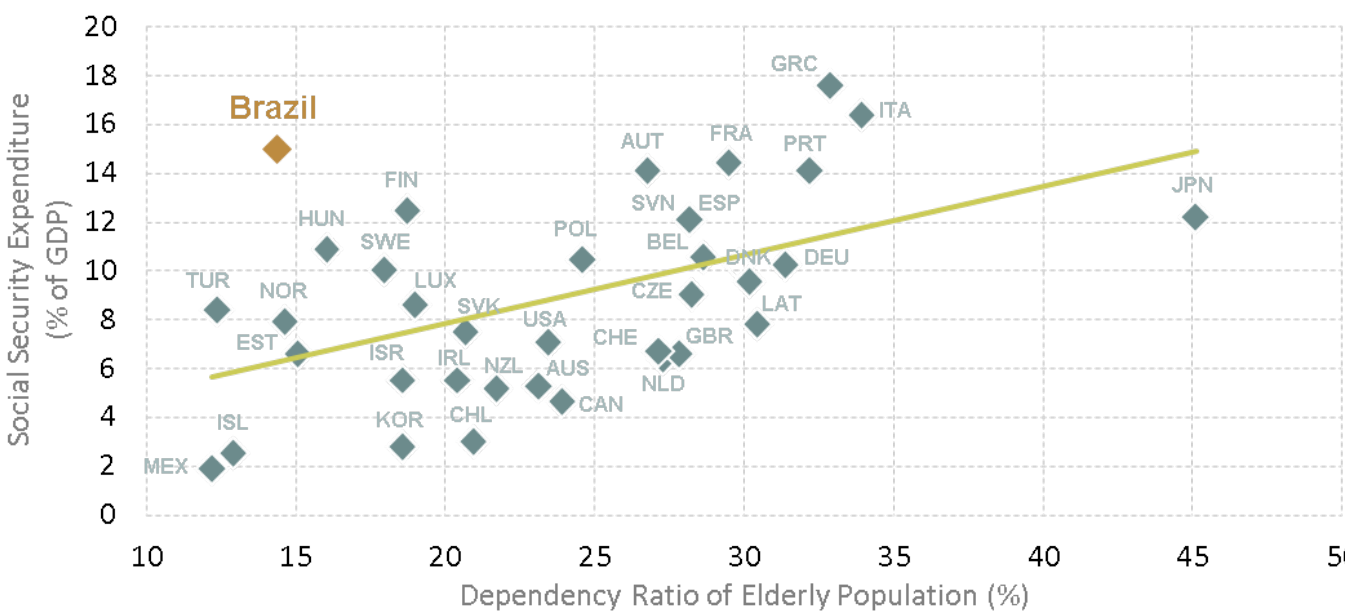
For a person that entered the labor force at age 20, men, As of 12/31/2016



Source: Brandywine Global

Chart 2: Dependency Ratio and Social Expenditure

Percent, As of 12/31/2016



Source: OECD, Macrobond

The urgency to pass social security reform has accelerated as its deficit widens from under 1% of GDP in 2015 to over 2.5% now. More Brazilians are approaching minimum retirement age. The weak economy has also dragged down social security revenues. Pension spending is increasingly crowding out other budget priorities.

Despite Pension Issues, the Market is Adopting a Glass Half Full/Half Empty Approach

The overnight policy rate is 6.5%, but the market is pricing an increase back to double-digit rates by the end of next year. Ten-year real rates are over 7%, which is unusually high relative to Brazil's own history and given the still negative output gap. Local positioning in currency futures has gone from being $5bn short to $17bn long.

On the other hand, 1-year options implied currency volatility is at 16.5, which is only in the 66th percentile of observations in the last 15 years. Sovereign spreads are not pricing a deterioration beyond the current BB credit rating. The Bovespa equity index is only down about 2% in local-currency terms year to date.

Legislative Spending Constraints Suggest Political Imperatives Prevail

The fact that the market is not pricing a worst case scenario is likely a function of the legislative constraints that will force the pension discussion to the fore. The spending cap rule of 2016 limits expenditure growth to the previous year's inflation rate. As early as 2019, social security spending will start to force cutbacks in discretionary programs as much as 25%. If the spending cap rule is breached, penalties will include freezes on government employee wages and headcount. The "golden rule" of 1988 constrains the government from issuing debt to finance ongoing current expenditures. Some financial maneuvering will be required to avoid this constraint.

In short, a scenario of legislative deadlock in the next administration would mean politicians in Brazil will have increasingly less discretion on how to spend money. Even the most cynical political observer would recognize this as a powerful incentive for politicians to address pension reform. But if history has taught us anything it is that election years in Brazil can be unpredictable and generate volatility.

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