Investors Bullish As Brazil Eyes Economic Recovery

With the impeachment of Dilma Rousseff, Brazil is finally breaking out of the doldrums that had gripped it over the past few years. Fundamentals of the Brazilian economy were never in doubt, but the political crisis had thrown one of the fastest growing economies of the world into a downward spiral. The worst seems to be over with the currency smartly recovering some of its loses and the benchmark index moving in the right direction.

Investors are showing renewed interest in Brazil as the economy showed definite signs of recovery in the last 12 months. Most investors and analysts are now optimistic about the future of the economy and expect robust growth in the coming years.

Since Ms. Rousseff's impeachment in August, Ibovespa, **the benchmark equities index, has gained over 40%. The Brazilian real has gained close to 23% against the US dollar this year**. Analysts expect the trend to continue and gain further momentum as President Michel Temer's investor-friendly government delivers on its promised economic reforms.

Economic Reforms & Growth

The first of these reforms took off in October 2016 when congress approved a constitutional amendment to prevent any real increases in budgetary spending for up to 20 years. This will allow public finances to find its feet again after the crash landing under the previous government.

According to AlejoCzerwonko, expert on emerging economies at UBS Wealth Management, the government is walking the talk, which has given strong momentum to the recovery. After a long time, **Brazil has started looking more attractive to investors than neighboring Argentina**, which was the favorite after its market-friendly president Mauricio Macri took over.

The previous government of Ms. Rousseff had scared away investors with its flawed policies. Her interventionist measures led to an alarming increase in budget deficits and a huge increase in government debt. Under Rousseff, government debt was close to 70% of the GDP. It was impossible to sustain this given Brazil's high interest rates. With investors staying on the sidelines, the economy went into a nosedive. It is expected to lose about 7% in two years by the end of 2016. The good news is that there are definite signs of a turnaround.

For the last five months, customer confidence has been on the rise and is at its peak since the start of 2015. Business confidence in the industry is also at its highest since July 2014. Inflation, one of the worst enemies of the economy, has come down and is at its lowest in over two years. This gives Banco Central, the country's central bank, some breathing space to reduce interest rates. It can now consider bringing down its benchmark SELIC rate from its current high of 14.25%.

Experts feel that the much anticipated reduction in interest rates will give further momentum to the recovery and improve market sentiment. David Beker, economist with Bank of America - Merrill Lynch team, expects a better than anticipated cut in interest rates. He forecasts a larger cut of 450 basis points against the market's expectation of 350 basis points. This will give a further boost to the markets. He expects interest rates to come down and eventually stabilize below 10% as inflation comes closer to the central bank's target of 4.5%.

Some market analysts are of the opinion that rather than fundamentals, it is the demonstration of political will and expectation of political stability that is driving market optimism and sentiment. President Temer is increasingly demonstrating the ability to break the political barriers that come in the way of reforms. His party came through the first round of municipal elections without any serious setbacks.

Although it didn't succeed in the largest cities of Rio and Sao Paulo, Temer's PMDB party got the largest number of mayoralties in the municipal elections. This has increased the chances of the president being able to get a market-friendly budget passed through the congress. It is likely to be followed by other bills like social security and labor reform. Congress is also considering smaller reforms like breaking the monopoly of state-owned Petrobras when it comes to getting access to major oil exploration blocks. These blocks may soon be opened to private operators.

According to AlejoCzerwonko, **the expected sequence of major reforms will keep the Brazilian equity market on an upward trajectory for some time**, despite the 12-month forward price/earnings ratio of the MSCI Brazil trading well above its historical average. Although the gains are unlikely to be as sharp as what was seen so far this year, he expects the uptrend to continue.

Analysts say the remarkable pace of the expected recovery will surprise most market players and observers. From a free fall during the past few years, the decline in the economy is likely to come down to about 3.5% this year, followed by a growth of about 1.5% in 2017.

Experts, however, don't expect reforms to sail through without any opposition. Some non-populist measures like pension system changes and amendment to labor laws are likely to run into difficulties due to public opposition. This puts some uncertainty over the continued support from the congress for the reform process.

With elections due in 2018 and campaigning likely to start towards the end of 2017, both the ruling party and the congress may be unwilling to push through unpopular reforms. The Petrobras corruption scandal that doomed Ms. Rousseff's government is another cause to worry. President Temer and members of his party are still not out of the woods as far as investigations in the scandal are concerned.

According to Walter Molano of BCP Securities, despite the doubts and the risks, Brazil continues to be the best place for investors this year. The market is likely to see major upswings as valuations still don't factor in the possibility of the likely reforms and economic growth. **Currently, Brazil is the best market for investors in Latin America, surpassing even Argentina. The low valuations and the right policy direction can be a huge winning combination for investors.**

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