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Emerging Markets Spotlight

Brazil has been one of our favorite Emerging Markets from late 2020, since it has delivered strong USD total returns despite a significant negative return from the MSCI Emerging Markets Index. October's election has returned Luiz Inacio Lula da Silva (Lula) as the president, a position he held from 2002-2010. As Lula is from the left-wing PT party, and given recent sharp negative market reactions to left-wing electoral successes in Chile, Colombia, and Peru, how has our view on Brazil changed?

We remain very positive on Brazil in both absolute and emerging market-relative senses. We do not see a Lula administration as a material risk to Brazil's economy or financial markets and continue to find attractive investment opportunities there.

Why are we sanguine about Brazil's political shift to the left?

1. The Brazilian economy remains in a relatively strong economic position, helped by both commodity prices and by the recovery from the previous downturn. These conditions are similar to those when Lula previously was in power – which was a good period for equity investors (during his previous presidency, MSCI Brazil returned an annualized 36.9% in USD terms; unlikely to be repeated, but evidence that a left-wing president isn't necessarily a problem). Export prices and the trade balance remain strong in historical terms, which support growth and the currency, while the domestic economy continues its recovery from the deep 2014-16 downturn (a recovery that is extended by the 2020 Covid-driven dip in activity); PMI surveys show continued expansion in both manufacturing and non-manufacturing activities.

2. Brazil's core institutions remain strong and market-friendly, which will constrain the more populist desires of the incoming administration. The central bank remains deeply orthodox regarding inflation-fighting, while the elections have skewed both Congress and Senate towards center and right-wing coalitions. Right-leaning coalitions have seen their share of seats increased from 46% to 49% in the lower house and from 31% to 44% in the upper house. As the fiscal spending cap (which Lula has indicated he would like lifted) is a constitutional measure, any reform would have to pass both houses.

3. Following on from that, since the start of 2021, monetary policy has been aggressively employed to reduce inflation with policy interest rates lifted from 2% to 13.75%. With both reported inflation and inflation expectations trending down, 2023 should see Brazil become one of the first major countries to move into a rate-cutting cycle, which should support both the economy and the equity market.

4. Equity valuations in Brazil are attractive, both against history and compared to other similarly sized emerging markets. The price/earnings ratio on 12 month forward consensus earnings of MSCI Brazil is just 6.6x, compared to a long-term average for Brazil of 11.2x and current levels of

21.6x for India, 14.6x for Saudi Arabia and 12.6x for Mexico. These levels would seem to price in a lot of political and policy risk.

In an emerging market-relative sense, and even in a global sense, Brazil's reasonably good conditions are extremely attractive. Net energy exports, a central bank that seems to have got on top of inflation, fiscal orthodoxy, moderate economic growth and attractive market valuations are conditions enjoyed by few countries anywhere. Given that, we think investors can live with a more left-wing government in Brazil. We certainly can.

Source for all data JOHCM/Bloomberg (unless otherwise stated)