



# Brazil: a country of contrasts

## Notes from the road



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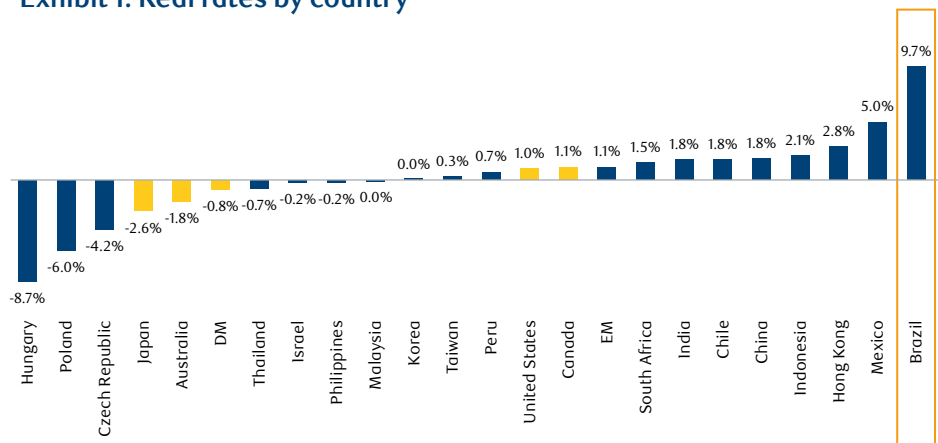
**“A key takeaway from our meetings with companies is the view that we have seen the worst in terms of political pessimism.”**

“It is typical Brazil; it could always be better but things are never as bad as they seem.” This quote, from one of the companies we met, summarises our thoughts following a recent research trip to Brazil.

Flying into Sao Paulo, what first strikes you is the huge contrast between the rundown favela on one side and the luxurious high-rise buildings on the other. This theme of contrasts featured throughout our trip to Brazil, not just in terms of the divide between rich and poor or the contrast between the urban and rural landscape, but also in terms of politics where there has been a significant shift to the left.

Brazilian corporates have been operating in an unpredictable domestic environment since the election of left-wing candidate, Luiz Inácio Lula da Silva (Lula), last October. Lula won the election with a very fine margin (less than 2%), thereby denying right-wing candidate, Jair Bolsonaro, a second term as President. Since then, there has been significant volatility in the Brazilian equity market, mainly due to uncertainty over the structural fiscal situation. The new Lula government is likely to run looser fiscal accounts as it looks to fulfil campaign pledges of increased social spending. This has concerned investors as the country is already faced with relatively high public debt, with a debt-to-GDP ratio of almost 80%<sup>1</sup>. While Brazil has some of the highest real rates amongst the major Emerging Market (EM) countries (Exhibit 1), following aggressive rate hikes by the Central Bank in the last couple of years, a concern is that looser fiscal policy going forward could mean higher rates for longer which could ultimately limit growth<sup>2</sup>.

Exhibit 1: Real rates by country

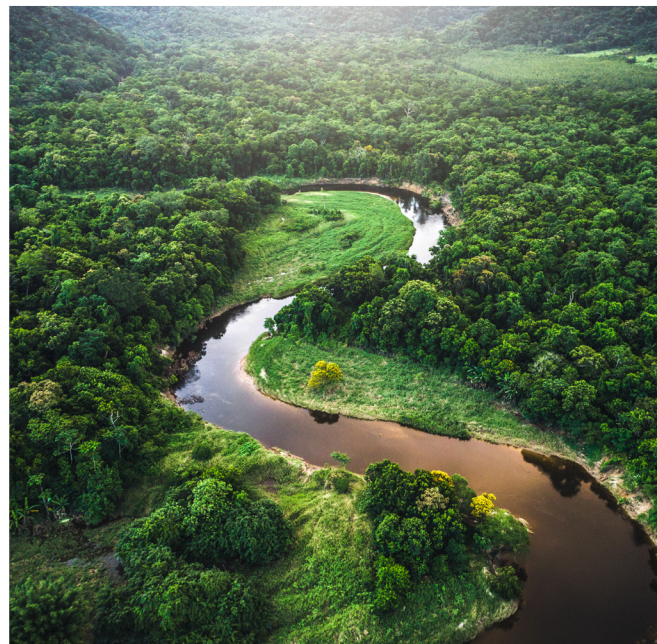


<sup>1</sup> Brazil faces economic headwinds as Lula prepares to take office ([www.ft.com](http://www.ft.com), December 2022).

<sup>2</sup> Morgan Stanley Research: Latin America Equity Strategy: A Global Early Cycle Play, February 2023.

Source: JPM Global Data Watch, March 2023. All data using forecasts for Q2 2023.

Arguably a lot of uncertainty has been reflected in equity market valuations already, with the Brazilian market trading at some of the lowest levels in its history (Exhibit 2)<sup>3</sup>. Our sense from the majority of companies we met was that they still see good long-term growth opportunities and strong fundamentals in a number of domestic sectors in Brazil, including Consumption, Financialisation and Healthcare. For a long time, we have felt that the quality of Brazilian corporates is high within EM when considering the quality of franchises, management teams, corporate governance and ESG policies.



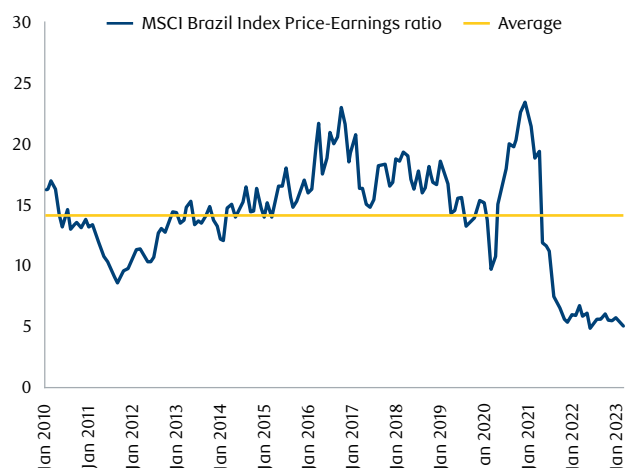
## “A simplification of the Brazilian tax system is key to improving the country’s competitiveness and productivity.”

Additionally, Brazil has several natural advantages, such as abundant water availability, favourable climate conditions with stable temperatures and large agricultural land reserve. It is a huge country, representing nearly half of South America and spanning four time zones. During our trip, we observed the stark contrast between the metropolitan cities of Rio and Sao Paulo, where the majority of the population reside, and the rest of the country which is abundant in rainforest and agricultural land. To put this into context, approximately 60% of the Amazon rainforest is found in Brazil, while it is estimated that 25% of the world’s known plant species live there<sup>4</sup>. These factors have helped the country to be among the main commodity producers globally<sup>5</sup>. Unfortunately, despite these advantages, corporates have generally been operating in challenging conditions due to the political situation in the country for many years. As one of the local investors we spoke to put it: “Brazil has great companies, and even during the political crisis in 2015, we didn’t see quality companies trading at these levels. However, they always have to think about how the government could complicate their lives.”

A key takeaway from our meetings with companies is the view that we have seen the worst in terms of political pessimism. Several companies indicated that there could be reasons for optimism if we were to see progress on reforms in the country, particularly on tax reform. A simplification of the Brazilian tax system is key to improving the country’s competitiveness and productivity, since Brazil has one of the most complex tax systems in the world<sup>6</sup>. While tax changes in Brazil have been under discussion for decades, proposals made in recent years did not go through in Congress<sup>7</sup>.

In spite of these potential positives, risks certainly remain. One of the largest potential concerns we heard about in our meetings was centred around Central Bank independence. The Brazil Central Bank (BCB) became independent by law in 2021<sup>8</sup>. However, Lula has repeatedly questioned the Central Bank’s decision not to cut interest rates more quickly and for keeping the inflation target too low<sup>9</sup>. Companies and investors in Brazil have become more worried about the credibility of institutions, following such comments by Lula.

**Exhibit 2: MSCI Brazil Index P/E valuations over time**



Source: MSCI, April 2023.

Reflecting on our trip, we feel that despite the uncertain political outlook, there are reasons to remain constructive on the Brazilian companies we invest in, given the quality of companies, track record of management, positive long-term company fundamentals, and cheap valuations. We continue to focus on areas of long-term structural growth through our portfolio themes, including Health and Wellness, Domestic Consumption and Financialisation.

<sup>3</sup> Itau: Equity Strategy: Market Data Monitor, March 2023.

<sup>4</sup> [www.wwf.org.uk/where-we-work/amazon](http://www.wwf.org.uk/where-we-work/amazon) and [www.nationsencyclopedia.com](http://www.nationsencyclopedia.com) - Brazil: Flora and Fauna.

<sup>5,6,8</sup> BofA Global Research: Brasílopedia: Chronicle of an election foretold, February 2022.

<sup>7</sup> BofA Global Research: New Brazil fiscal rule screams: Money – Tax changes ahead, April 2023.

<sup>9</sup> [Lula’s attacks on Brazil central bank alarm investors \(www.ft.com\)](http://www.ft.com).

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