



Lula elected president of Brazil

Thomas Smith, Manager of the Liontrust Latin America Fund

Lula has been elected president in Brazil for a third term having previously been president from 2003-2010. In the tightest election in recent history, Lula had just under 51% of valid votes to Bolsonaro's 49%, with the six million votes that separated them in the first-round closing to just two million. Lula will take office in January.

While clear policy details have been scarce, early in his campaign Lula distanced himself from the far left of his Workers' Party making it clear he will adopt pragmatic, centrist policies, and moved further to the centre in the latter stages. An early signal of this shift was his decision to choose former Sao Paulo Governor Geraldo Alckmin as his running partner, who will now become his Vice President. Alckmin, and the centre-right PSDB party that he founded in the 80s, have been in opposition to Lula's Workers' Party for decades, but this reflects Lula's understanding that to get elected and be able to govern the country effectively he needs to look beyond his leftist base. This increases the likelihood of at least a modest reform agenda which Brazil is still in need of to shore up government finances and raise economic growth potential.

Despite hailing from different ends of the political spectrum, the outlook for fiscal policy under both candidates was surprisingly similar. The spending cap will be amended next year and a new credible fiscal framework needs to be put in place. Debt to GDP, which had stabilised prior to the pandemic under President Temer before spiking in 2020, has fallen from 90% to 77% as both GDP and government revenues surpassed expectations, and has now returned to 2019 levels.

However, a new fiscal framework is essential to cement these improvements and ensure debt remains at sustainable levels. This is where concerns of a sharp move to the left under Lula will likely prove unfounded. Lula, above all, is a pragmatist. On the one hand, he won't have the money to spend as generously as he did during his previous terms as president, and on the other, the majority of Congress being from centre and centre right parties will mean he doesn't have the freedom or support to pursue radical or destabilising economic policies. Confirmation of this should come through the appointment of his cabinet, and in particular his finance minister, in the weeks ahead.

One area where the election of Lula is undoubtedly positive is his environmental policies. During his time as president deforestation fell by two thirds but more recently it has risen sharply and is on track to reach a fifteen year high this year. Lula's campaign directives promise to eliminate deforestation and promote a sustainable growth agenda. There are clear economic benefits from reduced deforestation and better environmental policies. Some of Brazil's agribusiness exports to the EU could be at risk due to the increase in deforestation, as well as their OECD candidacy and the EU-Mercosur trade deal. Brazil also has significant potential to benefit from the sale of carbon credits. An initial step to develop a local carbon market has been taken but further legislation is required, and this is likely to be accelerated under Lula.

With the sharp derating that has occurred over the past two years, despite the strong earnings recovery, Brazilian equities are now trading at less than seven times earnings, a more than 50% discount to five- and ten-year averages and 35% discount to the broader emerging markets, having historically traded at similar valuations. This is also at a time when inflation is falling, interest rates have peaked and look set to fall in the first half of next year, a situation very different to many other emerging and developed economies.

The central bank was very proactive in addressing inflationary pressures and began hiking interest rates in March last year. This early and decisive action helps to explain the Brazilian real's strong performance this year being one of the few currencies globally to have appreciated against the dollar. This is a far cry from the 2013 taper tantrum when Brazil was labelled one of the 'fragile five' economies under pressure as the Fed began talking about tapering QE and raising interest rates.

Recession fears could continue to weigh on regional and global equities through the months ahead but relative and absolute valuations are already at extreme levels, suggesting significant risks are already priced in.

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