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Global Equities

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Brazil – a mid-year review

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Coming into 2024, the prospects for Brazilian equities looked good. The post-pandemic recovery has been stronger than anticipated and, with a sharp fall in inflation, the central bank was one of the first globally to lower interest rates, while valuations remain severely depressed. Yet even as economic data continues to be healthy and inflation remains under control, equities have struggled – why is this and how might the market fare over the remainder of the year and into 2025?

Solid outlook coming into 2024

Despite having handsomely outperformed global equity markets in both 2022 and 2023 (+15% vs. -18% in 2022 and +33% vs. +23% in 2023 in USD), valuations were still depressed at a material discount both to their own history and broader emerging markets. The Brazilian Central Bank (BCB) moved early and decisively to hike interest rates in the face of the post-pandemic surge in inflation, raising rates from 2% to 13.75%, beginning the cycle a full twelve months before the Federal Reserve.

By the second half of 2023, inflation had already fallen back into the central bank's target range, allowing it to begin lowering interest rates, with many more cuts expected through 2024. Even with some of the highest real interest rates in the world, Brazil's economy has surpassed expectations in the post-pandemic recovery and robust growth has continued this year; higher commodity prices had driven the trade balance to record levels, providing a further boost to both the economy and the currency.

The primary risk that has concerned investors in recent years has been the level and trajectory of government debt and the need to get this onto a sustainable path. A combination of the reforms introduced by former presidents Temer and Bolsonaro, which included the landmark pension reform and limits on government spending, and the better-than-expected economic data allowed for government debt as a proportion of GDP to fall from a pandemic high of 88% down to 74% – back to levels last seen in 2017-18.

What has changed over the first half of the year?

Fast forward six months and economic data continues to be strong, inflation is under control and the trade balance is again setting new records, yet Brazil is one of the worst performing major markets so far this year. There are several reasons for this, both external and domestic, but the largest factor has been the substantial resetting of expectations for interest rate cuts to be delivered by the Fed and other developed market central banks. Back in January, the consensus was for six or seven cuts in the US through 2024. Now the chances of the first cut coming in September is little better than 50:50 and no more than two cuts are expected by December.

As the Brazilian Central Bank began cutting interest rates in August 2023 at a pace of 0.5% per meeting for six consecutive meetings, the expectation was that rates could fall to around 8% (from nearly 14%) by the end of 2024. Lower interest rates would help in a number of ways: reducing the financial expenses of companies, lowering the cost of capital to help stimulate investment and faster economic growth, raising the net present value of future cash flows, and triggering the reversal of domestic fund flows back into equities from fixed income. With government debt yielding 11-13%, domestic investors have favoured bonds over equities, while when yields were 7-10% in 2017-21 the money was flowing in the opposite direction.

The BCB slowed its pace to 25 basis points in May and held rates steady in June, with only one further cut (to 10.25%) expected in the second half of the year. Many central banks across emerging markets have become more hesitant to cut interest rates aggressively in the face of a more hawkish Fed, mainly due to concerns it may weaken their currencies and lead to inflationary pressures reemerging. The BCB should be able to resume more regular cuts next year when a more synchronised interest rate cycle emerges.

Domestic events have exacerbated the challenges. The new fiscal framework was well received when passed last year and attention turned to the tax reform which aimed to simplify Brazil's byzantine tax system without increasing the burden. Initial progress was good with the VAT reform consolidating five taxes into just two, resembling India's highly successful Goods and Services Tax in many ways. However, since then the Lula government has been reluctant to cut spending to meet the targets set out in the fiscal framework, instead looking to raise some taxes to fund shortfalls. This has resulted in the market questioning the fiscal discipline of the government, leading to a weaker currency and slightly higher inflation expectations.

How might the market fare going forward?

As a difficult first half draws to a close, what does this mean as we look ahead to the rest of 2024 and to 2025? The two issues noted above will continue to be important to monitor. Should the Fed proceed with its first cut in September and then deliver regular cuts through next year, a lot of pressure will be alleviated from central banks across emerging markets who will then be able to resume their own interest rate cutting cycles. If this scenario doesn't materialise then we are likely to see many remain on hold for longer than they would really like. Similarly, Lula has a history of being pragmatic and this time is likely to be no different. With a clear message from the market that the government needs to reaffirm its commitment to fiscal responsibility, discussions are already underway about where spending cuts can be found in order to respect the targets laid out in the fiscal framework. Uncertainty remains but there is a clear path to an easing of the challenges faced both externally and domestically in the months ahead.

On top of this, valuations have derated further and at less than seven times forward earnings, the Brazilian market is now trading at a record 40% discount to the broader emerging markets and a 34% discount to its own ten year average. This is despite solid earnings growth supported by the strong economic expansion and both profitability and return on capital being significantly above emerging market averages. Even as global recession fears have eased, significant risks continue to be priced into Brazilian equities. Expectations are clearly very low that the two key challenges that have weighed on share prices so far this year can ease in the quarters ahead.

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