Heartwood
Investment Management

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Investment Insight

Weekly Insight

Brazil clears the first hurdle, but there's an uphill climb

Latin America has been a significant underperformer relative to the broader Emerging Markets asset class over the last two years. The MSCI Latin America has fallen minus 33% versus minus 16.5% for the MSCI Emerging Markets Index during the period 31st May, 2014 to 31st May, 2016. Much of this underperformance has been down to the major index weight Brazil, which fell 40% over the same period (all figures in US dollar terms).

There has been a confluence of factors driving lower equity returns. Latin American economies are hugely dependent on commodity exports. Price falls seen across the commodity complex over the last couple of years have undermined growth and contributed to a significant deterioration in public finances across the region. Worsening terms of trade for many countries has led to higher inflation and weaker currencies. In countries like Brazil, where governments have also overspent, the central bank has had to respond by increasing interest rates, rather than easing policy to support growth. Resultantly, business and consumer confidence have been severely knocked.

The overhang of political scandals is a key risk

Furthermore, Brazil's political landscape has been woven by a complex web of corruption scandals, culminating with President Dilma Rouseff's upcoming impeachment trial. The political situation remains fluid. Operation 'Car Wash', the term given to the ongoing corruption investigations, continues to cherry pick ministers, even within the newly installed administration of the interim President, Michel Temer. The Planning Minister, Romera Juca, is the latest politician to be implicated amid accusations that he had conspired to obstruct the corruption investigation. Juca has now taken a leave of absence from the government.

Nonetheless, the new President appears determined to push through a reform agenda. Despite the loss of Juca, who was considered a key figure in steering through reforms in Congress, Temer's government overcame its first hurdle this week as the lower house approved a bill to reduce spending (totalling $33.4 billion). His newly appointed Finance Minister, Henrique Meirelles, a former banker, is also keen to push ahead with reforms to the pension system, easing the burden on government finances.

The jury is still out on whether Brazil's government can achieve its objectives. We are not expecting a smooth reform path and setbacks are likely to occur along the way, particularly as the current government does not have popular support. The overhang of scandals remains a key political risk and this keeps us cautious from an investment perspective in the near term.

Tentative signs of economic stabilisation

There are a few tentative signs that economic data is stabilising. Brazil's first quarter GDP growth contracted less than expected at minus 5.4% (annualised). While the better than expected outcome was driven by a one-off boost to government consumption, which has been blamed on the outgoing Dilma administration's attempt to salvage its government, there are other signals to suggest that the worst could be over. Business confidence and fixed asset investment growth remain at historic lows, but the rate of contraction was slower in the first quarter of this year.

Inflation remains at a multi-year high (9.3% year-on-year in April), although it is expected to soon peak due to the impacts of the base effect and lower economic activity. Potentially, this will give Brazil's central bank more room to support the economy and cut interest rates. Under the scenario of ongoing market reforms and falling inflation, these forces would create a positive environment for an equity market that has sold off significantly. However, we are not yet convinced that these trends have taken hold. Brazil is starting to look more interesting, but it is not out of the woods yet.

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