

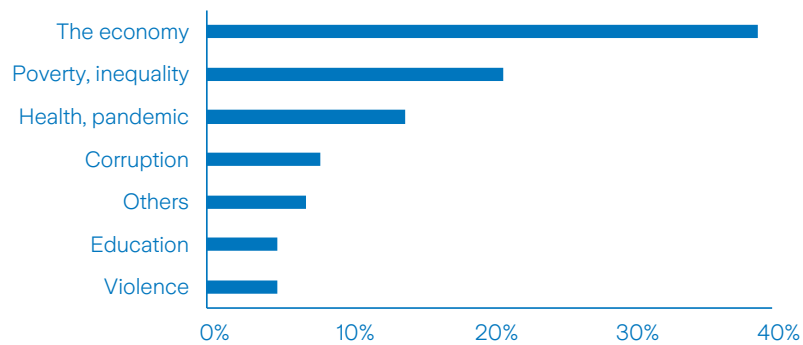
# Decision time for Brazil



## A clear choice between known candidates for the Presidency

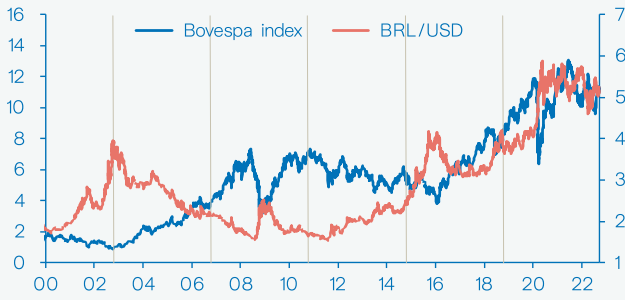
On October 2 national elections will take place in Brazil. More than 156 million Brazilians will elect a new President, governors for all 26 states as well as the Federal District, 513 representatives for the Lower House, one-third of the 81 members of the Senate, and local state representatives (1,059). In case either the President or any of the candidates for governor fail to reach a 50% majority, a second round will take place on October 30. The next government will take office on January 1, 2023. Opinion polls are showing a polarized presidential election and we expect a very tight outcome that will only be decided in the second round between the incumbent, Jair Bolsonaro, and the former President Lula (2003-2010). During the previous presidential election in 2018, when the economy was emerging from a deep contraction, the election focused on fighting against corruption and electing an outsider to replace traditional politicians. The current situation is different, economic themes are the main concern, becoming key drivers for the election. Considering that inflation is well above target, the rising fiscal risk, and the expected economic deceleration due to monetary tightening, the economic outlook for 2023 is challenging, and restoring fiscal credibility will be one of the main tasks of the next administration. Despite market concern about fiscal stability volatility of local assets has not increased notably during this campaign period as investors know the frontrunners well and both appear to be showing prudence. Market pricing also suggests no clear preference for either of the candidate despite their fundamental differences. Historically, equities have rallied after presidential elections, which offers some encouragement once a clear outcome emerges, particularly as valuations are attractive currently.

### What is Brazil's principal problem?



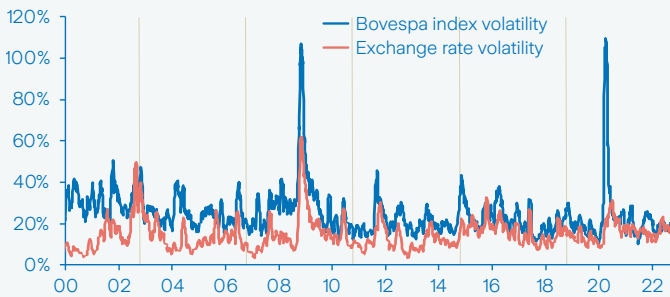
Source: Genial/Quaest

### Evolution of the equity market and the exchange rate



Sources: Bloomberg. Note: Bars represent previous elections

### Equity market and exchange rate rolling 30 day volatility (%)



Sources: Bloomberg. Note: Bars represent previous elections

### The next administration will need political agreement in Congress

Brazil is facing the most polarized presidential race in decades. We expect a very tight result in the presidential election, in which there is eleven candidates. The leading candidates are former president Luiz Inácio Lula da Silva (PT-Workers Party, left-wing candidate), current President Jair Bolsonaro (PL-Liberal Party, far-right-wing candidate), Ciro Gomes (PDT-democratic Labour Party, centre-left-wing candidate), and Simone Tebet (MDB-Brazilian Democratic Movement Party, centre-right-wing candidate).

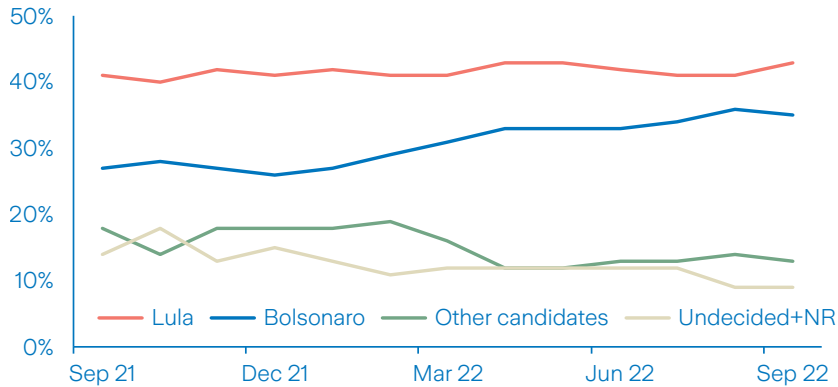
In Brazil, the elected government must build a coalition in Congress to implement its policy. Furthermore, in order to pass most of the economic reforms, the next administration will require a constitutional amendment, which can only be passed with a three-fifths majority in both the Lower House and the Senate respectively. The parties that support Lula and Bolsonaro, the frontrunners in polls, represent around one-third of Congress in each case. The remaining members of Congress are from the centre, or support other candidates. As neither Bolsonaro nor Lula will have enough votes to implement their reforms independently, they will be obliged to move to the centre in order to gain support. Therefore, the role of Congress, and members that represent the centre in particular, will be crucial in preventing any policy shifts that may significantly affect the economic and financial outlook.

source: iStock



## Lula and Bolsonaro are well ahead in the polls

### Aggregated polls for the first round Presidential Election



Source: PollingData, ZIG

There have been many different polls with various methodologies and outcomes during this election period. All of them show Lula and Bolsonaro as the frontrunners in the first round, with the other candidates far behind, and former President Lula leading by 10pp on average. If polls are correct, Brazil will be the latest LatAm democracy to turn to the left, following Peru, Chile, and Colombia.

Bolsonaro, however, has been trying to reverse polls by increasing social spending and implementing a battery of measures to reduce taxes and the gasoline price. At the beginning of the year, the gap in favour of Lula was ~15pp, while recently, it had diminished to ~8pp. Although the effect of the latest economic measures on voting intentions is not yet fully reflected in the polls, the gap is expected to close further. Furthermore, the economic performance in 2022 also benefits Bolsonaro. Economic activity has continued to surprise the upside, with Q2 GDP growing at a more solid pace than in Q1, while inflation decelerated rapidly. Therefore, even though polls have shown a preference for Lula, the outcome is still too close to call. It is also worth noting that the polls are limited to only interview ~2,500 voters on average per round, which is a low representation in a country with more than 156 million voters.

## A challenging economic environment faces both candidates

The economy in Brazil is facing several challenges in 2023. Economic activity will likely decelerate due to the higher interest rate and the uncertainty of the global outlook, while inflation will remain above target. Furthermore, the fiscal anchor is losing credibility and is under pressure. The next administration will have to deal with an increase in fiscal spending of ~1.6% of GDP as some of the measures announced this year will become permanent. Therefore, the economy will be the key theme of this election with a focus on the next President's need to restore fiscal credibility.

The fiscal anchor for the economy is the spending cap. It limits the increase in fiscal spending to the previous year's inflation. The rule was created in 2016 after a sharp deterioration in public finances. During the last three years, the rule has been breached in order to finance the fiscal stimulus brought about by the pandemic and extraordinary spending to increase social programs and reduce inflation pressures. These exceptions have undermined its credibility and sustainability, leading to the need for a new fiscal anchor, something both of the leading candidates favour.

Lula proposes to revoke the fiscal rule and replace it with a new fiscal anchor signalling that his government intends to be fiscally responsible but mentioned that fiscal stabilisation must come from economic growth rather than by reducing fiscal spending. Bolsonaro mentioned that his government is committed to fiscal consolidation, promising to maintain the spending ceiling, but without confirming how. He will likely try to implement a model based on a target for the public debt as the new fiscal anchor. Hence, depending on the level and path of the public debt, fiscal spending may deviate from inflation if indebtedness is reduced. Abandoning the fiscal anchor will undermine investor sentiment and business confidence, affecting economic activity. Nevertheless, changes in the spending cap require a constitutional amendment. We believe neither Bolsonaro nor Lula will have enough votes in Congress to modify the constitution without a political agreement. Therefore, total revocation of the spending ceiling is unlikely, so some fiscal anchors will remain in place. Nevertheless, until it is confirmed, fiscal uncertainty will continue.

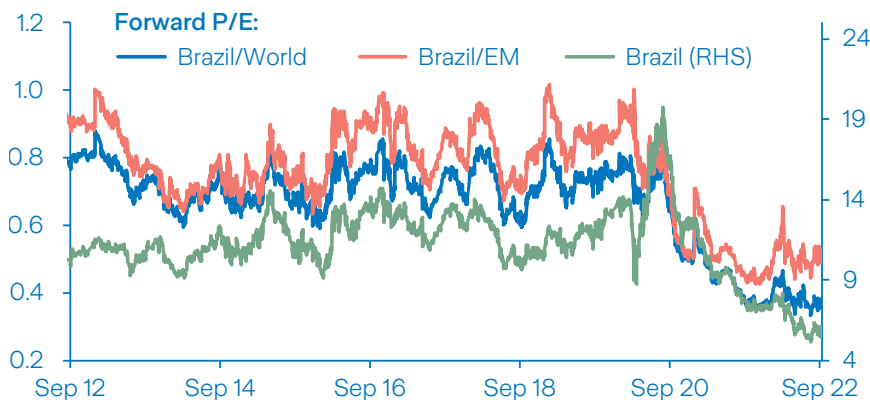
Regarding the fiscal policy, the leading candidates will both try to increase the social program and implement a tax reform. Lula wants to improve and rename the current

cash transfer program. The new Bolsa Familia will replace the current monthly BRL 600 Auxilio Brasil, increasing it by BRL150 per child for up to six years. The implementation of the additional resources will be gradual, but it is unclear how it will be financed. Furthermore, he wants to implement a tax reform that not only simplifies the tax system but also reduces evasion and implements a progressive income tax, increasing exemptions for lower-income contributors and increasing rates for higher earners, but without specifying the size. Bolsonaro also promises a monthly increase of BRL 200 for the social program to maintain it at the current BRL 600. The increase will benefit those who start working. Nevertheless, it is unclear if he will be able to keep his promise as the additional contribution to the program was not included in the budget proposal. Also, he wants to implement a tax reform focused on simplifying the tax system and adjusting the income tax threshold, while workers that earn up to five times the minimum wages will be exempted from paying taxes.

Public sector employment represents more than 10% of the total working population in Brazil, and wages account for one of the largest parts of government spending. Bolsonaro's administration has been trying to implement a reform to reduce this spending, but it is stagnated in the Lower House since September 2021. Bolsonaro will continue to promote this legislation if elected, which will likely improve the efficiency of the public sector labour market and will allow reducing wages and working hours when personnel expenditures exceed the Fiscal Responsibility Law. Lula has not shown any signs of lowering this spending but has indicated that he will seek to reduce inequalities in public sector wages and equalize wages between the public and private sectors.

One of the most significant differences between the leading candidates is the privatisation policy and the size of the state. Privatising state-owned enterprises has been one of the goals of Bolsonaro's government. In June 2022, he privatized Eletrobras, the largest energy company in LatAm and one of the main SOEs in Brazil. If given a second term, Bolsonaro would likely continue to promote additional privatisations and reduce the state's role to concentrating only on essential activities. Conversely, Lula would not continue with the privatisation process, and public banks will have an important role in the credit market for households and SMEs.

### Equity market valuation and relative value



Source: Bloomberg

## Conclusion

The economic outlook for the next administration will be challenging. The composition of Congress is likely to remain more centrist, and whoever is elected President will require Congress's support to reach political agreements and implement the government's program. Therefore, a massive shift in policy is unlikely, keeping a fiscal anchor on the public account and limiting the possibility of implementing reforms that undermine the institutional model and the economic and financial outlook. We believe that implementing other reforms that improve efficiency in the public sector are much needed to reduce fiscal uncertainty and positively impact economic activity. Furthermore, a new credible and sustainable fiscal anchor is critical for containing spending, reducing the risk premium, and increasing the attractiveness of already discounted Brazilian financial assets. The equity market is trading at only a 6 times forward price/earnings ratio, more than two standard deviations below its 10-year average. Furthermore, comparing Brazil with the broader emerging market universe, the former also looks attractive. Considering that the tightening cycle is in a different stage compared to other markets and economic activity is surprising positively, we believe that financial assets in Brazil are attractive and may become more interesting when fiscal uncertainty reduces.



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