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PENDAL

Spotlight on Emerging Markets

Why we're not worried about Brazil's lean to the left

**A monthly insight from James Syme, Paul Wimborne and Ada Chan,
managers of Pendal's Global Emerging Markets Opportunities Fund**

BRAZIL has been one of our favourite emerging markets since late 2020.

Over that time it's delivered strong USD total returns despite a significant negative return from the MSCI Emerging Markets Index.

October's election has returned Luiz Inacio Lula da Silva (Lula) as the president, a position he held from 2002-2010.

Lula is from the left-wing PT party, which may raise concerns after recent, sharp negative market reactions to left-wing electoral successes in Chile, Colombia and Peru.

How has this affected our view on Brazil?

We remain very positive on Brazil in both absolute and emerging market-relative senses.

We do not see a Lula administration as a material risk to Brazil's economy or financial markets. We continue to find attractive investment opportunities there.

Why are we sanguine about Brazil's political shift to the left?

Here are four reasons:

1. **The Brazilian economy remains in a relatively strong economic position, helped by commodity prices and recovery from the previous downturn.** These conditions are similar to when Lula previously was in power, which was a good period for equity investors. (During his previous presidency, MSCI Brazil returned an annualised 36.9% in USD terms. This is unlikely to be repeated, but it's evidence that a left-wing president isn't necessarily a problem). Export prices and the trade balance remain strong in historical terms. This supports growth and the currency, while the domestic economy continues its recovery from the deep 2014-16 downturn (a recovery that is extended by the 2020 Covid-driven dip in activity). PMI surveys show continued expansion in both manufacturing and non-manufacturing activities.

2. **Brazil's core institutions remain strong and market friendly.** This will constrain the more populist desires of the incoming administration. The central bank remains deeply orthodox regarding inflation-fighting, while the elections have skewed Congress and Senate towards centre and right-wing coalitions. Right-leaning coalitions have seen their share of seats increased from 46% to 49% in the lower house and from 31% to 44% in the upper house. The fiscal spending cap (which Lula has indicated he would like lifted) is a constitutional measure, so any reform would have to pass both houses.

3. **Since the start of 2021 monetary policy has been aggressively employed to reduce inflation with policy interest rates lifted from 2% to 13.75%.** With reported inflation and inflation expectations trending down, 2023 should see Brazil become one of the first major countries to move into a rate-cutting cycle. This should support its economy and equity market.

4. **Equity valuations in Brazil are attractive historically and compared to other similar-size emerging markets.** The price/earnings ratio on 12-month forward consensus earnings of MSCI Brazil is just 6.6x. This compares to a long-term average for Brazil of 11.2x and current levels of 21.6x for India, 14.6x for Saudi Arabia and 12.6x for Mexico. These levels seem to price in a lot of political and policy risk.

In an emerging market-relative sense – and even in a global sense – Brazil's reasonably good conditions are extremely attractive.

Net energy exports, a central bank that seems to have got on top of inflation, fiscal orthodoxy, moderate economic growth and attractive market valuations are conditions enjoyed by few countries anywhere.

Given the above, we think investors can live with a more left-wing government in Brazil.

We certainly can.

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