Brazil – An Example of Growth and Risk in Emerging Markets

Investing in emerging markets has historically taught us that this is an area of volatile economies. Though steadily improving, Brazil is one such example. A country that has faced challenges throughout the 20th century history, the most recent events bring to focus this country’s geopolitical state. Brazil has made great strides in driving towards stability, but structural reforms are needed to occur in order to continue its economic progress. There is now a question of whether progress can continue. However, the green shoots of growth show encouraging signs.

Corruption allegations against Brazil’s President drove a selloff last week which caused the Ibovespa stock index to fall in one of the sharpest declines since the 2008 financial crisis. Reportedly, President Michel Temer endorsed a bribe to Eduardo Cunha, the former House Speaker in Congress. Mr. Temer is to be investigated for corruption and obstruction of justice by Brazil Supreme Court and faces growing calls for his resignation. Temer came to power when former President Ms. Dilma Rousseff was impeached in 2016, convicted of manipulating the federal budget to conceal the nation’s economic problems. The budget deficit rose to 10% under Rousseff’s leadership. Her impeachment led many analysts to believe the country’s failing global profile could be restored under new leadership.

Temer’s pro-business agenda promised to enact fiscal reforms as one of his goals. Pension reform is necessary to ensure Brazil’s fiscal solvency. Investors had high expectations of reduced government spending and the successful passing of reforms. Recent charges are a setback and compound shorter-term risks. Brazilian assets have been selling off in the face of widening political scandal. Uncertainty and volatility may continue in the Brazilian markets, if fears intensify. Also, the ability to pass these measures diminishes as the 2019 elections loom closer. The current situation within Brazil reminds us that emerging markets are a volatile asset class and investors in these markets must remain vigilant.

For the past year, emerging economies have seen relative growth recover. Healthier earnings, better macroeconomic policies and more robust fiscal discipline have helped to improve valuations. While improved, they remain at a discount in comparison to developed markets. After last year’s downturn, currencies and commodities have adjusted from falling global commodity prices and these risks have also diminished. The incoming economic data looks relatively attractive for emerging markets and the International Monetary Fund (IMF) has projected growth of 4.6% and 4.8%, in 2017 and 2018, respectively*. In general, these economies are expanding and have continued to do well despite the Fed’s tightening of the U.S. monetary policy.

In light of this upward momentum, Brazil’s recovery expectations have been stronger than most for the following reasons. A sign of positive recovery is reflected in the easing of Brazil’s inflation. It is expected to decrease to 4.3% this year, down from over 8% in 2016. Brazil’s GDP is forecasted to grow to +1.0% in 2017 up from -3.6% in 2016*. The country has a growing, young middle class which translates to consumer spending. The central bank has increased its foreign currency reserves. The stock market has had a strong run in the last 18 months, is larger and more liquid. Other developments include improved management by Brazilian banks and better corporate governance regulations. Based on this encouraging data, Brazil is in a better position to help mitigate market volatility. Structural change could be delayed as the likelihood increases that Temer will not be able to stay in power. However, improved fundamentals may help this country over the long term, despite short term shocks.

The situation with Brazil reminds us to take a nimble approach when investing in emerging markets because of the macro and risk backdrops which accompany them. Good fundamentals can become overshadowed by nearer-term risks such as weaker commodities, stronger dollar, higher interest

*Sources: T. Rowe Price; IMF, World Economic outlook-December 2016; Emerging Markets Economic Outlook Q2 2017
rates and political instability, to name a few. While conditions within emerging markets continue to reflect healthy growth, and while we still recommend this asset class for aggressive portfolios, we also recommend staying fully diversified to help limit concentrated bets and minimize portfolio volatility.

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