Morgan Stanley

INVESTMENT MANAGEMENT

Tales From the Emerging World

Brazil: Restoring the Fiscal Anchor Is Key

EMERGING MARKETS EQUITY TEAM | MACRO INSIGHT | 2022

AUTHORS

ERIC CARLSON
Head of Sustainability, Emerging Markets Equity Team

JITANIA KANDHARI
Head of Macro and Thematic Research, Emerging Markets Equity Team

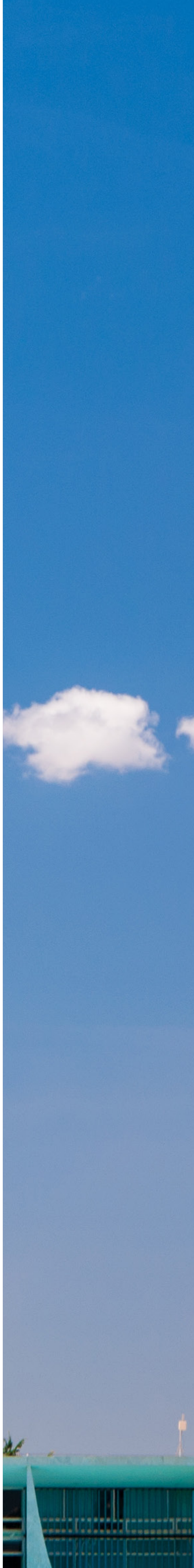
EDUARDO WISBRUN
Vice President/Analyst, Emerging Markets Equity Team

For decades the fortunes of Brazil, the world's fourth largest commodity exporter, were closely tied to global commodity prices.[1] Its economy, per capita income, value of the Brazilian currency and Brazilian stocks were positively correlated with the moves in the global commodity indexes.[2] The arrival of right-wing populist President Jair Bolsonaro in 2019 and the COVID-19 pandemic created a break in the past relationship preventing the country from fully benefiting from the rise of its main exports. Commodity prices have recovered from the COVID-19 lows, but Brazilian stocks and its currency have not yet returned to their pre-pandemic peaks.[3] Back in April of 2021, we warned that with Bolsonaro misfiring on economic reform, it may take another election to set things right (*Brazil: Populism Versus Commodities*) so that the country can benefit from the current boom in commodities exports.

That election is now here.

On a recent trip to Brazil, we had a chance to witness firsthand the impact of the presidential election that pits left-wing Luiz Inácio Lula da Silva, better known as Lula, against the incumbent Bolsonaro. Opinion polls suggest Lula is on track to win back his old job. Yet, this election could prove to be less disruptive than previous cycles. After three years of Bolsonaro's chaotic rule, this vote is more of a referendum on the current president than a leftward political shift, similar to what took place in Chile and Colombia.

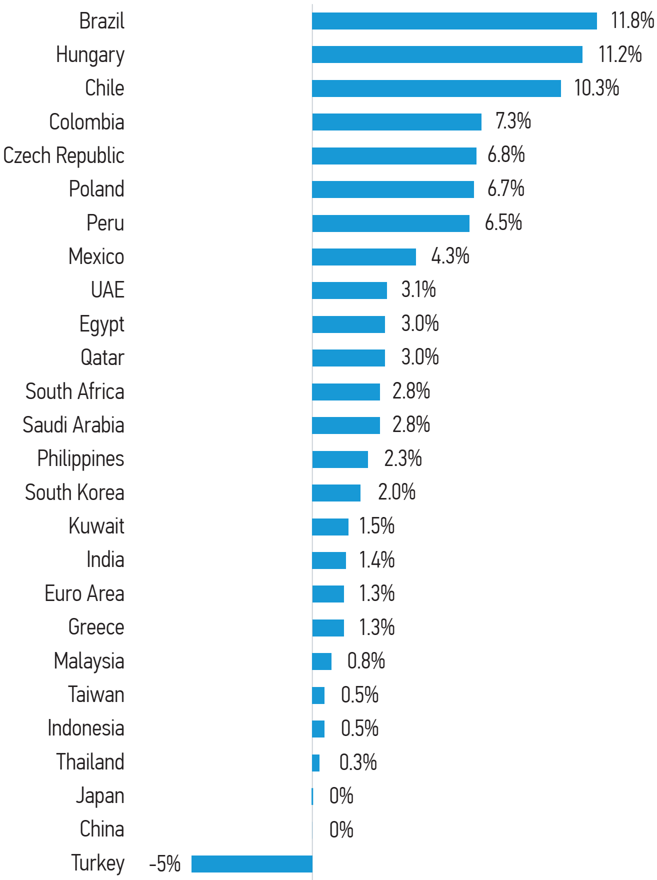
[1] MSIM, Bloomberg, FactSet, Haver.
[2] MSIM, Bloomberg, FactSet, Haver.
[3] MSIM, Bloomberg, FactSet, Haver.




DISPLAY 1

Brazil Has Acted Aggressively to Fight Inflation

Percent change in policy rates: January 2021 – August 2022

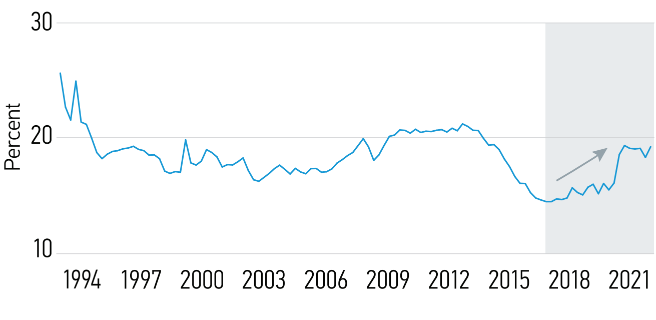


Source: MSIM, Bloomberg, FactSet, Haver.

DISPLAY 2

Investment Is Back on the Rise in Brazil

Investment as a percentage of GDP



Source: MSIM, Bloomberg, FactSet, Haver.

Lula's likely return to Alvorada Palace once seemed too farfetched even for producers of the country's popular telenovelas. Described by former U.S. President Barack Obama as "the most popular politician on earth," Lula left office in 2010 with an 80% popularity rating.[4] The adulation did not last as a series of scandals tarnished his reputation and he was sentenced to 12 years in jail in 2018 for corruption and money laundering. Most Brazilians blamed Lula's big-spending Workers' Party for the country's rampaging crime and corruption. Yet, after serving 580 days in jail, the Brazilian Supreme Court last year annulled his sentence, freeing him to make his presidential bid.

Bolsonaro faces an uphill battle, with rejection rates higher than Lula. Nine months ago, this would have been a source of worry for the markets. But as we discovered in our meetings, business leaders seem comfortable with either candidate winning, a marked departure from past elections. Even Lula mixes his hard-left rhetoric with a moderate choice for vice president, Geraldo Alckmin, the former Governor of Sao Paulo. In addition, recent institutional reforms have empowered the National Congress, controlled by center-right parties, to play a bigger role in checking the excesses of the executive branch.

The Central Bank of Brazil (CBB) continues to be a strong independent institution and maintains high credibility as evidenced by raising rates sharply early last year in a bid to stanch inflation. This was at a time when the U.S. Federal Reserve was not even talking about raising rates in the U.S., their thinking instead focused on the transitory nature of inflation. In a series of aggressive hikes, the CBB raised rates 12 times, by an aggregate 1,175 basis points, from a historic low of 2.0% to 13.75%.[5] The central bank is now edging closer to ending its rate-hiking cycle and is likely to be the first in the world to ease rates. We expect rate cuts to be enacted in mid-2023 as inflation peaks.

The July 2022 Consumer Price Index declined to 10 percent and economists expect inflation to slip further, to around 6 percent, a year from now.[6] Government tax reductions on fuel have pushed electricity and gasoline prices lower, and with crude oil prices now also trending lower, we believe the worst in terms of inflation is over.

Bolsonaro's efforts to reform and privatize state-owned enterprises (SOEs), push through new private infrastructure concessions and ease labor laws were overshadowed by his combative and chaotic management style. Nevertheless, he has overseen an economic team that enacted reforms that are cumulatively yielding material improvement in the economy and business climate; investment at 20% of GDP being one of the key positive inflections for the country that was in a deindustrialization mode for the past decade.[7]

In 2021, manufacturing made up 10 percent of the economy, the country's agricultural-related businesses accounted for

[4] Bloomberg, The Economist.

[5] MSIM, Bloomberg, The Wall Street Journal.

[6] MSIM, Bloomberg, FactSet, Haver, Reuters.

[7] MSIM, Bloomberg, FactSet, Haver.

nearly 7 percent and both are now well positioned to benefit from a commodities tailwind in a post Ukraine war world.[8] Investments in infrastructure and agriculture are led by private firms and banks, rather than SOEs and state banks. The law that formalized the independence of the CBB included a constitutional amendment that allowed private investment in sewerage works. Year to date, foreign direct investment flows have reached nearly $53 billion, within striking distance of what the central bank had predicted for the entire year.[9] The underlying economic activity remains vibrant, and the labor market is buoyant with unemployment rate at 9.1%, a seven-year low.[10]

The Achilles heel of Brazil remains its fiscal situation. The benefits of the long-awaited pension reform passed by Bolsonaro is already diluted by pandemic and inflation spending. Credibility in the government's ability to maintain spending caps is eroded. Restoring the fiscal anchor will be the primary economic challenge of the new administration. For now, the market seems comfortable that the progress will proceed in the right direction.

The incoming president will inherit a much more positive structural economic situation. If Bolsonaro were to win, this will likely lead to further economic reform and more privatization, at the cost of sensational headlines in the global press. If he leaves, voluntarily or after a fight, the Brazil that Lula will inherit will be in much better shape than when his successor, Dilma Rousseff, left office. And his room to maneuver will be constrained, by a country still decidedly center-right in the main. Once Brazil is past this inflation cycle, the economy should be ready to grow based on a revitalized private sector investment, a thriving agricultural and commodity sector, a credible central bank and a competitive currency.

Risk Considerations: There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. Stocks of **small-capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk). **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Cryptocurrency (notably, Bitcoin)** operates as a decentralized, peer-to-peer financial exchange and value storage that is used like money. It is not backed by any government. Federal, state or foreign governments may restrict the use and exchange of cryptocurrency. Cryptocurrency may experience very high volatility.

[8] World Bank.

[9] Reuters. Data as of July 2022.

[10] MSIM, Bloomberg, FactSet, Haver, IBGE.

DEFINITIONS

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

IMPORTANT INFORMATION

DISTRIBUTION

This material is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

MSIM, the asset management division of Morgan Stanley (NYSE: MS), and its affiliates have arrangements in place to market each other's products and services. Each MSIM affiliate is regulated as appropriate in the jurisdiction it operates. MSIM's affiliates are: Eaton Vance Management (International) Limited, Eaton Vance Advisers International Ltd, Calvert Research and Management, Eaton Vance Management, Parametric Portfolio Associates LLC and Atlanta Capital Management LLC.

This material has been issued by any one or more of the following entities:

EMEA:

This material is for Professional Clients/Accredited Investors only.

In the EU, MSIM and Eaton Vance materials are issued by MSIM Fund Management (Ireland) Limited ("FMIL"). FMIL is regulated by the Central Bank of Ireland and is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.

Outside the EU, MSIM materials are issued by Morgan Stanley Investment Management Limited (MSIM Ltd) is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

In Switzerland, MSIM materials are issued by Morgan Stanley & Co. International plc, London (Zurich Branch) Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland.

Outside the US and EU, Eaton Vance materials are issued by Eaton Vance Management (International) Limited ("EVMI") 125 Old Broad Street, London, EC2N 1AR, UK, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority.

Italy: MSIM FMIL (Milan Branch), (Sede Secondaria di Milano) Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy. **The Netherlands**: MSIM FMIL (Amsterdam Branch), Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. **France**: MSIM FMIL (Paris Branch), 61 rue de Monceau 75008 Paris, France. **Spain**: MSIM FMIL (Madrid Branch), Calle Serrano 55, 28006, Madrid, Spain. **Germany**: MSIM FMIL (Ireland) Limited Frankfurt Branch, Große Gallusstraße 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG), **Denmark**: MSIM FMIL (Copenhagen Branch), Gorrissen Federspiel, Axel Towers, Axeltorv2, 1609 Copenhagen V, Denmark.

MIDDLE EAST

Dubai: MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

U.S.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT

LATIN AMERICA (Brazil, Chile Colombia, Mexico, Peru, and Uruguay)

This material is for use with an institutional investor or a qualified investor only. All information contained herein is confidential and is for the exclusive use and review of the intended addressee, and may not be passed on to any third party. This material is provided for informational purposes only and does not constitute a public offering, solicitation or recommendation to buy or sell for any product, service, security and/or strategy. A decision to invest should only be made after reading the strategy documentation and conducting in-depth and independent due diligence.

ASIA PACIFIC

Hong Kong: This material is disseminated by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this material have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this material shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore**: This material is disseminated by Morgan Stanley Investment Management Company and should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia**: This material is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. Calvert Research and Management, ARBN 635 157 434 is regulated by the U.S. Securities and Exchange Commission under U.S. laws which differ from Australian laws. Calvert Research and Management is exempt from the requirement to hold an Australian financial services licence in accordance with class order 03/1100 in respect of the provision of financial services to wholesale clients in Australia.

Japan: For professional investors, this material is circulated or distributed for informational purposes only. For those who are not professional investors, this material is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This material is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

Explore our site at **www.morganstanley.com/im**