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The Impeachment Proceedings of Dilma Rousseff

Brazil's lower house voted on April 17th to impeach President Dilma Rousseff by a vote of 367 to 137. The process now moves to the Senate, where the country's 81 senators are expected to vote sometime in the next few weeks, although a final date has not been set. For almost a year, Rousseff's opposition has been trying to impeach her for allegedly manipulating the government budget in 2014. A simple Senate majority vote to impeach Rousseff could remove her from power, installing her vice president, Michel Temer, as president.

This week we will look at the Brazilian presidential impeachment proceedings and the circumstances that have led to the impeachment. We will briefly describe the recent political history of the country and look at the specifics of Brazil's economic development. As usual, we will conclude with market ramifications.

Recent History

Brazil's population of more than 200 million makes it the fifth largest country in the world in terms of population. Population growth has been rapid as the absolute number has doubled over the past 30 years. According to IMF data, Brazil was the ninth largest country in terms of nominal GDP in 2015.

We need to remember that Brazil is still very new to the international markets as well as to democracy. The country was ruled by the military from 1964 to 1985. During this

time, civil rights were severely repressed while the military tried to implement economic reform. In 1985, the military peacefully ceded power to civilian rulers. The constitution was ratified in 1988 and the country held its first democratic election in 1989 with great enthusiasm. The new government was able to get inflation under control through extensive price freezes, and its new currency was introduced in 1994.

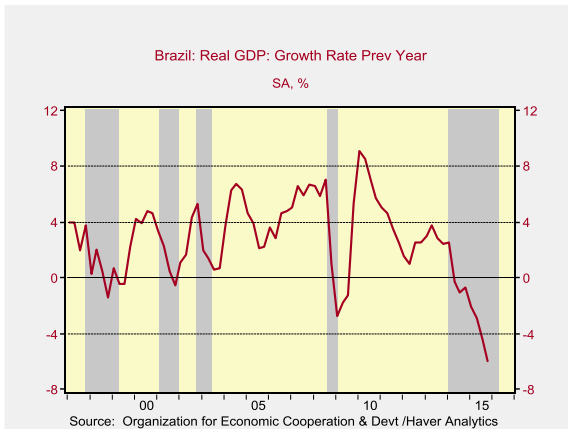
The Workers' Party, moderately left-wing, first came to power in 2002 when Luiz Inacio Lula da Silva (known as Lula) won a resounding victory. Lula remains popular to this day, aided by the booming economy experienced during his two terms. Dilma Rousseff, also a member of the Workers' Party, was elected president in 2010 largely on the back of Lula's popularity. Rousseff started her second presidential term in 2014.

Rousseff has been involved in left-wing politics for most of her political career. She fought against the military dictatorship under the Marxist movement and was jailed and tortured by the regime. She was one of the founders of the Democratic Labor Party, serving in several regional positions for the party. In 2000, she left the party after an internal dispute and joined the Workers' Party. She became the energy minister before running for president in 2010.

Rousseff gained popularity during her presidency for lowering energy and food tax rates, populist measures which boosted support among the poorest constituents. In the beginning of her presidency, the country benefited from rising Chinese demand for Brazilian commodities which led to rising prices for those commodities. This allowed

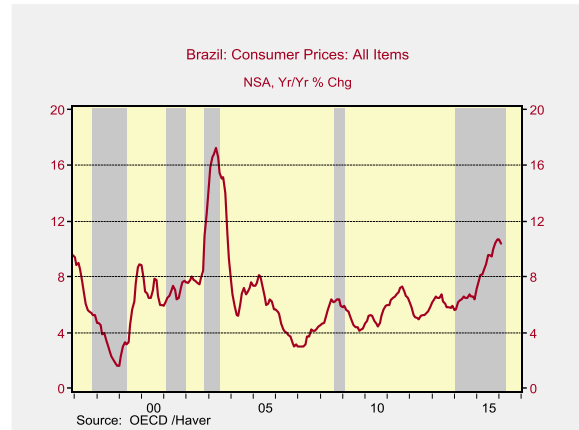
the government to increase public spending without addressing economic inefficiencies. These inefficiencies have been exposed in recent years as a result of slower global growth, leading to discontent among her constituents.

Brazil is rich in minerals and crude. The country has benefited greatly over the past decade from the surge in commodity prices. The wealth effect was multiplied by capital inflows and credit expansion. Recently, discontent has grown as economic growth has slowed. The chart below shows the country’s annual change in economic growth, with the shaded areas indicating recessions. Brazil has been in a recession since Q2 2014, with seven consecutive quarters of negative growth.



Brazil’s historical growth has relied on commodity exports, especially soy beans, iron ore and oil. With grain prices falling on increasing supplies and industrial metals prices falling on soft demand, Brazil’s main exports have been hit on both price and quantity.

At the same time, consumer inflation has surged.



Inflation has been caused by supply side constraints. Infrastructure has remained inadequate as railway systems are in their infancy, the river system is not accessible enough for reliable transportation and the roadway systems are in poor condition. The natural shortfalls of the river system are especially relevant since the country produces many low value-to-weight commodities, which are best suited for river transport.

Historically, Brazil has been one of the highest inflation and lowest growth countries among emerging economies. For example, inflation reached 2,000% per year in the 1980s. The solution to this high inflation was an arduous path of capital controls, heavy bank regulation and deep cuts to the government’s budget. In the early 2000s, investors dove into emerging markets; this, coupled with Brazil’s falling inflation as a result of deep-seated reforms, resulted in large inflows of capital into the Brazilian markets. As a result, the Brazilian currency, the real, has appreciated and in turn made Brazilian manufacturing uncompetitive. It is important to remember that the Brazilian economy is mostly commodity-related and low skilled, so exports need to compete on pricing rather than the value-added sphere.

At the same time, the country has been successful in poverty reduction, lifting about a quarter of its population into the middle class category in the past 10 years. This is no small feat. By comparison, China moved the same proportion of people out of poverty over the course of 30 years. With that being said, inequality remains a persistent problem for the country.

Government

Brazil's government aims to alleviate inequality and maintain support by fiscal programs, which result in outsized government spending, approximately 40% of GDP. Government spending in comparable countries stands near 25%. In the U.S., government spending accounts for about 21% of GDP. In Brazil, public spending is geared toward income support, with little funds designated for investment. Although the country needs huge infrastructure improvements, the government is spending only about 2% of its funds on infrastructure. By comparison, emerging markets, in general, are spending about 5% on infrastructure, with China an outlier at 10%. Additionally, Brazil spends 5% of GDP on pensions for civil servants, more than twice the amount it spends on infrastructure spending.

Infrastructure spending in Brazil is technically difficult due to geography, and requires large amounts of investment and high levels of expertise. However, linking the interior and the various coastal cities would sustain growth and encourage further foreign direct investments. This would help to alleviate inequality, especially in the rural areas.

Corruption

Corruption is a widespread problem for Brazil, with the government and state-owned enterprises often involved in bribery,

favoritism, over-invoicing and other illicit or dishonest activities. Corruption is so common that *The Economist* reports that 352 of Brazil's 594 sitting politicians are facing criminal charges, including bribery, electoral fraud, kidnapping and homicide.¹

Some observers claim that corruption has become institutionalized under the current government, which leads us to the current impeachment of Rousseff.

Rousseff's Impeachment

Rousseff's impeachment charges are based on claims that accuse her of manipulating the government's budget in 2014 by using accounting tricks to mask the size of the government deficit during her second presidential election season. Rousseff has denied the allegations, saying that the accounting methods (known as "backpedaling") were widely used. She also accuses Vice President Michel Temer of orchestrating a "coup against democracy." It is fundamentally a legal dispute, which is spurred on by political infighting.

Since the lower house already voted to proceed with her impeachment, the process now moves to the Senate, which will vote at an unspecified time in the coming weeks. If a simple majority of the Senate votes for impeachment, she will be removed from office for up to 180 days while her case is evaluated. If two-thirds of the Senate votes to impeach her, Temer will officially assume the presidency.

It looks increasingly likely that Rousseff will be impeached as popular and political opinions have turned against her. Her Workers' Party was in a coalition with Temer's Brazilian Democratic Movement

¹<http://www.economist.com/news/leaders/2169539-1-tarnished-president-should-now-resign-time-go>

Party, but Temer's party broke the coalition, deciding to pursue her impeachment.

Rousseff's options at this point are limited. If the Senate approves her impeachment, she could appeal the decision to the Brazilian Supreme Court, but the court is unlikely to overturn the impeachment since it has already turned down one appeal from her.

She could also propose early elections. Although she would not be able to remain in power, calling for early elections would keep the current vice president Temer from automatically assuming the presidency. Early elections would also allow for the still-popular ex-President Lula to run for office, which would keep the incumbent Workers' Party in power.

The impeachment saga took an unexpected and bizarre twist when VP Temer inadvertently released a recording of himself practicing a speech as if Rousseff's impeachment was final, promising "national salvation" and calling for unity.² Reportedly, Temer's party has joined forces with the country's third largest political party, the Brazilian Social Democracy Party, to form a government if Rousseff is impeached. He also indicated areas of focus for the new government. The list of possible important legislative measures for the new government headed by Temer include cutting government spending while maintaining an appropriate level of welfare spending, simplifying the country's complicated tax code and implementing labor market reforms. Temer also indicated that it is important to increase the private sector's role in the economy, meaning that privatization would be more likely as selected parts of Petrobras are already slated to be privatized. Overall, Temer would be

more business-friendly than Rousseff, but instability is likely to continue. Corruption remains a widespread problem, with Temer also involved in the Petrobras corruption investigation for funds used for his 2014 re-election.

Petrobras Scandal

Separately, Rousseff and many other politicians are involved in a large-scale corruption scandal involving the state-owned oil company, Petrobras. Although Rousseff is not directly implicated in the scandal, she served as the company's chairwoman for several years. Still, the scandal is likely contributing to her negative perception during these impeachment hearings. The corruption scandal involved a group of contractors who habitually overbid on projects for Petrobras, syphoning the extra funds illegally to their own bank accounts and using a portion of it to bribe politicians and Petrobras officials.

Ramifications

It looks increasingly likely that Rousseff will be impeached. However, the problems that Brazil faces are not likely to be resolved in the near term. Being a natural resource exporter, the country is disproportionately affected by global economic weakness, especially the deceleration of Chinese growth. Additionally, Brazil faces structural problems that are unlikely to be addressed in the current political environment, even if Rousseff is removed from power. More than anything, the widespread corruption needs to be addressed, but it seems unlikely that extensive corruption reform will be approved within the current system where almost 60% of serving politicians are involved in some sort of criminal investigation.

In the short run, however, the outcome of the impeachment could signal the country's

² According to reports, Temer sent a group of lawmakers the 14-minute audio text on WhatsApp.

willingness to become more politically transparent, which will determine the direction and strength of capital flows. If Rousseff is replaced by a more market-friendly Temer, capital inflows would likely increase in anticipation of economic openness, including privatization. Brazilian risk markets have already discounted the effects of the political change. The Bovespa index is up almost 34% in dollar terms as the chart below shows. In fact, the index has been the second best-performing country index after Peru.



(Source: Bloomberg)

waning among voters. However, protests could strengthen if fiscal spending is cut. For the new government, controlling inflation and continuing social welfare programs are key priorities to avoid social unrest. Rousseff has used social spending to placate the masses, but if the new government is serious about getting its spending under control then these social programs may have to be reduced. Additionally, inflation could rise further if government subsidies for fuel and electricity are cut. If inflation picks up, investors should pay close attention to the central bank’s response. Tightening monetary policy could constrain economic growth in the already weak manufacturing sector.

Overall, we expect the political and social situation in Brazil to remain tumultuous. Brazilian equity markets have performed well in anticipation of Rousseff’s impeachment but may be volatile in the coming months due to uncertainty regarding potential changes in government policy.

On the social front, we do not expect protests to intensify if Rousseff is impeached as her popularity has been

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