Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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September 26, 2016

Goodbye, Dilma. Hello, Michel.

On August 31, Brazilian President Dilma Rousseff was impeached on charges of breaking budgetary laws, ending nine months of political infighting. The Brazilian Senate voted 61-20 to permanently remove her from her presidential post. Rousseff's former vice president, Michel Temer, led the impeachment process and has assumed the presidential duties.

This week we will look at the current political landscape of Brazil under the new president. We will briefly describe the country's recent political history and look at the specifics of Brazil's economic development. We will discuss the conditions that led to the impeachment and the new president's possible policy path. 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.

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.

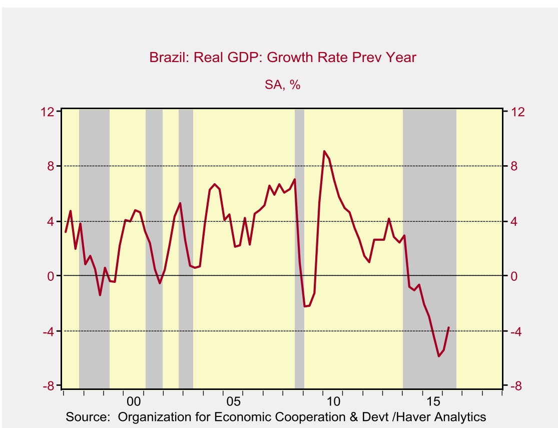
The Workers' Party, which is moderately left-wing, first came to power in 2002 when Luiz Inacio Lula da Silva (known as Lula) won a resounding victory. Lula remains popular to this day, aided by the booming economy experienced during his two terms. Dilma Rousseff, also a member of the Workers' Party,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

Rousseff has been involved in left-wing politics for most of her political career. She fought against the military dictatorship alongside 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. In 2000, she left the party after an internal dispute and joined the Workers' Party. She became Brazil's energy minister before running for president in 2010.

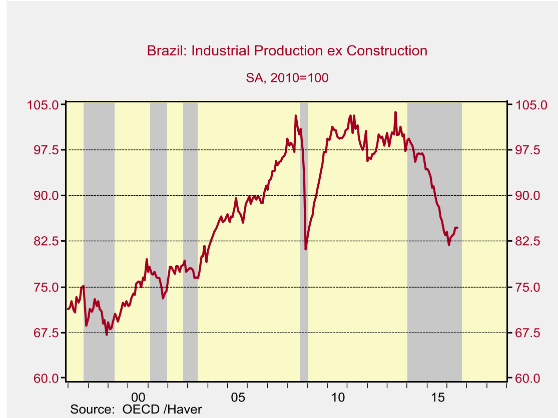
Rousseff gained popularity during her presidency for lowering energy and food tax rates, populist measures which boosted support among the poorest constituents. In the beginning of her presidency, the country benefited from rising Chinese demand for Brazilian commodities which led to higher commodity prices. 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, and 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 nine consecutive quarters of negative annual GDP growth. The Olympics created a slight uptick in growth, but the year-over-year growth rate for the most recent quarter remained at -3.8%.

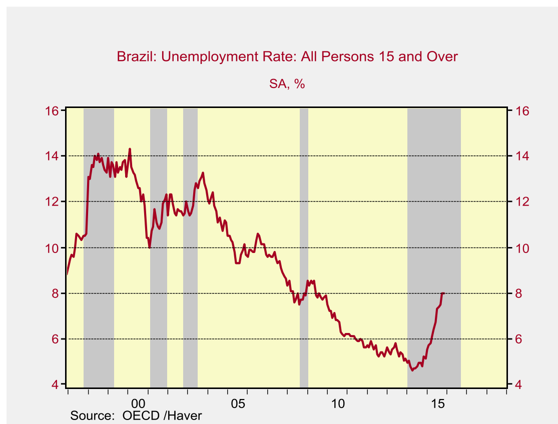


Historically, Brazil's growth has relied on commodity exports, especially soy beans, iron ore and oil. With grain prices falling due to increasing supplies and industrial metals prices falling on soft demand, Brazil's main exports have been hit hard on both price and quantity.

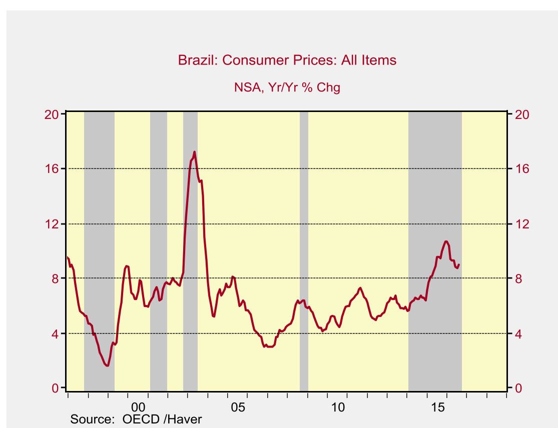


Industrial production has been weak, as the chart above shows.

Slow growth has caused the unemployment rate to surge from its low of 4.6%, reached in 2014, to 8.0% in the most recent data.



At the same time, consumer inflation remains high. CPI stands at 9.0% annually.



Inflation has been caused by supply side constraints. Infrastructure has remained inadequate as the railway system is in its infancy, rivers are not accessible enough for reliable transportation and roadways 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 following 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 relies on low skilled workers, 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 Brazil.

Government

Brazil's government aims to alleviate inequality and provide support through fiscal programs, which has led to 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 are spending about 5% on infrastructure, in general, 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.

Building infrastructure in Brazil is technically difficult due to its 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 investment. This would help alleviate inequality, especially in the rural areas.

Corruption

Corruption is a widespread problem for Brazil, with 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, nearly 60%, are facing criminal charges, including bribery, electoral fraud, kidnapping and homicide.[1] Transparency International ranks Brazil the 76th most corrupt out of 168 countries ranked. This pegs Brazil's corruption level similar to India, Thailand and Zambia.

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[1]http://www.economist.com/news/leaders/21695391-tarnished-president-should-now-resign-time-go

Separate from the budget manipulation accusations that led to Rousseff's impeachment, she and other politicians were involved in a large-scale corruption scandal concerning the state-owned oil company, Petrobras. The scandal, nicknamed "Car Wash," involved a group of contractors who habitually overbid on projects for Petrobras, siphoning the extra funds illegally to their own bank accounts and using a portion to bribe politicians and Petrobras officials. Allegedly, some of these funds were used for the Rousseff/Temer 2014 presidential campaign.

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

Conditions Leading to Rousseff's Impeachment

Rousseff was impeached after being found guilty on the charges of government budget manipulation 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 their accounting methods (known as "backpedaling") were widely used. In her speech following her impeachment vote in the Senate, she accused her opponents of a coup d'etat and compared this vote to her imprisonment and torture under the military rule.

Michel Temer, who served as vice president under Rousseff for two terms and once a close political ally, has become a vocal opponent of Rousseff since December 2015. Temer was trained as a lawyer, but has had a long political career, including presiding over Brazil's Congress from 1995 to 2002 when Brazil liberalized its economy and implemented a program of privatizations.

Temer belongs to the Brazilian Democratic Movement Party (PMDB), which he led for 15 years. PMDB has been in the ruling coalition with several parties as it avoids a strict ideological track in order to form coalitions with various parties. Although the party does not have a defined ideology, it could be characterized as a generally centrist party that includes a wide range of ideologies from conservatives to populists to nationalists.

PMDB grew out of the opposition party under the military rule before 1979. Prior to Temer, only one president has come from PMDB. However, it has also had a large representation in both the Congress and Senate over the past decade as one of the three largest parties. The party has not had presidential candidates in the recent elections, instead focusing on winning congressional and gubernatorial elections. Under Brazilian electoral law, parties launching presidential candidates cannot make any alliance at the state level unless such state coalitions are comprised of parties allied at the country level. PMDB was in coalition with President Lula of the Workers' Party before forming a coalition with Rousseff in 2011. The coalition was re-elected in the 2014 presidential election for its second term.

However, relations deteriorated between the two parties and their leaders in August 2015, when Temer indicated that the president was refusing to include his party's economic goals in policymaking. In October 2015, PMDB released a political document called "A Bridge to the Future," which outlined several policies his party viewed as economically necessary. The program focused on labor reform, privatization and tighter fiscal spending. Labor reform called for raising the retirement age and less labor market regulation. Privatizations and economic liberalization called for new private sector partnerships, simplifying the country's complicated tax code and decreased market regulations. Tighter fiscal controls aimed to cut health and education spending and reduce welfare benefits. The policies were viewed as market friendly given the increase of the private sector's role in the economy.

During this time, VP Temer wrote a private letter to Rousseff complaining that he had been excluded from key decisions. The letter was leaked to the press. Interestingly, in a speech in New York last week, Temer implied that Rousseff was impeached because of her position on economic policy, rather than the actual charge against her of budget manipulation.[2] Temer specified that his party, then part of a coalition with Rousseff's party, started working toward removing her from office after she refused to implement more business-friendly policies on the basis that they were not part of her electoral mandate.

In December 2015, the lower house of Congress officially opened impeachment proceedings and found Rosseff guilty on charges of budget manipulation. In March 2016, PMDB officially abandoned the coalition and formed a new center-right conservative coalition that excluded Rousseff's Workers' Party.

Rousseff was suspended from her presidential role in May 2016 after the Congress voted to proceed with her impeachment and the Senate waited to vote on the permanent impeachment. Temer assumed the role of interim president while Rousseff was suspended. On August 31, the Senate voted to permanently impeach Rousseff and Temer succeeded to the presidency.

Ramifications

Rousseff's permanent impeachment and Temer's assumption of the presidential post has pacified the discontented populace. However, the political landscape is only part of the issue that the country has to deal with. The lethargic economy, increasing inflation and surging unemployment rates all contribute to the general discontent. The hope of Temer's supply side policies have temporarily calmed the population; however, the honeymoon period may be short and will depend on Temer's ability to push through his proposed reforms. His programs are expected to find populist resistance, especially during the current difficult economic environment. The population is looking for improved living standards, but also for reduction in corruption and more government accountability. Temer's policies could improve conditions long term; however, they will almost certainly be disadvantageous to the masses in the short term as benefits are reduced and labor reforms are implemented.

At the same time, corruption is still an issue. We note that corruption reduction was not an independent part of his party's "Bridge to the Future" program (although he does call for "reestablishing trust"). It is unlikely that accountability would improve given the widespread corruption. Temer may be able to push through some of his proposed reforms, but he will want to maintain popular support as the country heads toward another presidential election in 2018.

For the new government, controlling inflation and continuing social welfare programs are key priorities to avoiding social unrest. Previous presidents have used

[2] https://theintercept.com/2016/09/23/brazils-president-michel-temer-says-rousseff-was-impeached-for-refusing-his-economic-agenda/

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.

Markets have already discounted the proposed liberal policies of the new president. The Brazilian Ibovespa stock index has risen over 60% since its January 2016 low. Some of the gains were likely the result of improved investor confidence in emerging markets, but it was also caused by expectations of a more market-friendly president.

(Source: Bloomberg)

The chart above shows the Ibovespa index over the past year. We have inserted two red lines—one in May when Rousseff was suspended and the other in August when she was permanently impeached and Temer was sworn in as president. Brazilian risk markets have already moved strongly. Although some further short-term gains may be likely, investors may need to see Temer's effectiveness and political cunning in pushing through his proposed economic reforms before we would see a more sustained market move.

In the short run, Temer's ability to implement reforms could signal the country's willingness to become more politically transparent, which will determine the direction and strength of capital flows. If Temer is able to push for privatizations, capital inflows would likely increase in anticipation of further economic openness. Parts of Petrobras are already slated to be privatized and if these initial privatizations go through, both direct and indirect foreign investment are likely to follow.

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September 26, 2016

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