Confluence Investment Management

Weekly Geopolitical Report

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Dilma or No Dilma?

During the first round of Brazilian presidential elections on October 5, the incumbent Dilma Rousseff of the Workers' Party received 42% of the votes while Aecio Neves of the Social Democracy Party received 34%. Since none of the candidates received more than 50% of the vote, the second round of runoff elections will be held on October 26. Currently, Rousseff leads the polls, signaling a likely continuation of state-centric policies.

The results from these elections are significant for the Brazilian domestic economy as well as foreign investors. Whether Rousseff or Neves wins, the next president will inherit a low growth and high inflation environment. Additionally, the incoming president will have to deal with high government spending while maintaining the high social spending that the ruling party has relied on for populist support. The growing domestic middle class is demanding an end to corruption and better social services.

Foreign investors are also closely watching these elections as a win for Neves could signal a more market-friendly political environment with better government fiscal responsibility and political transparency.

This week, we will look at the Brazilian presidential elections along with the current political and economic environment in the country. 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

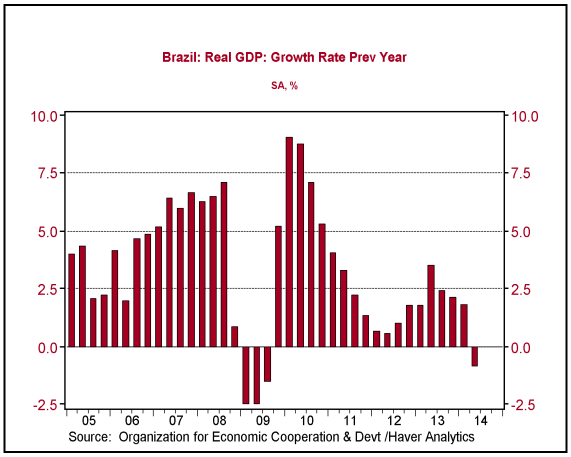
Brazil's population of 199 million makes it the fifth largest country in the world in terms of population. Population growth has been rapid as the absolute number has doubled over the past 30 years. Brazil is the seventh largest country in terms of total economic size.

We need to remember that Brazil is still very new to the international markets as well as 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, and the country held its first democratic election in 1989 with great enthusiasm. The new government was able to get inflation under control through onerous reforms. The constitution was ratified in 1988 and its new currency was introduced in 1994.

Over the past decade, Brazil has benefited greatly 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 and inflation has risen.

Brazilian economic growth has mostly faltered due to weakening global commodity demand. The Brazilian central bank forecasts that Brazilian GDP growth will be 0.7% in 2014. The chart below shows the yearly GDP growth rates, which topped at

9.1% in 2010, when commodity demand from China boosted growth.



Brazil's recent 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, Brazilian manufacturing has become less competitive and its importance has been overshadowed by its reliance on commodities. Additionally, the country's strong currency and structural inefficiencies have made Brazilian companies uncompetitive in the export markets. Trade barriers, direct competition from China and inherent difficulties brought on by Brazil's lack of infrastructure to accommodate for its size and difficult terrain have also hindered export growth.

Infrastructure has remained a constant bottleneck for the country as railway systems are in their infancy, the river system is not accessible enough for reliable transportation and the roadway systems remain in poor condition. This is especially relevant since the country produces many low value-to-weight commodities.

Mercosur, the South American trade bloc which includes Brazil, is likely to remain a drag on the economy due to its trade barriers. Additionally, Mercosur's charter has limited Brazil's ability to sign trade agreements with other countries as a new agreement for any member country requires unanimous approval from all the member countries.

Commodity Addiction

Given the importance of commodity exports to the country, the political process is also shaped by the needs of commodity producers. The crops that have historically done particularly well in the country are coffee and sugar, neither one of which is easily mechanized. Therefore, both industries need large pools of low-skilled labor. Due to this need there is a great disincentive to advance educational opportunities, resulting in a small pool of skilled workers and a large number of unskilled workers, in turn creating labor and infrastructure bottlenecks. During periods of strong growth, the lack of skilled labor tends to cause capacity constraints, making it difficult to boost productivity. Thus, Brazil faces persistent inflation pressures.

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 for the country, with 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.

Inequality

Brazil has successfully lifted 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. Brazil has been successful in alleviating poverty for the elderly as a result of comprehensive pension reform. However, this has left little money for educational reform, and commodity dependence has created a need for a large, low-skilled labor pool. However, in order to sustain the pace of improvements in living standards and support social mobility and equality, the availability and quality of education is crucial. Additionally, Brazil has been undergoing slowing population growth rates since the 1960s, which will soon lead to a significant demographic transition. The aging population and current low investment levels into human capital could hinder growth possibilities.

That being said, the country's large middle class supports the growing domestic market demand and makes the economy more robust. This is not the case for many emerging markets. A study by the Brookings Institute indicates that about half of Brazil's population is now considered middle class compared to 10% in China. Even through the recent economic slowdown, the expanding middle class has maintained its expectations for uninterrupted economic growth. Given the country's commodity reliance and the slowdown in end market demand, it is unlikely that either candidate will be able to meet these enhanced expectations.

Government

Brazil's government spending is large, approximately 40% of GDP. Government spending in comparable countries stands at about 25%. At these levels, public funds crowd out private investments. Since government investment is centrally controlled, it is generally less market efficient than its private counterpart. Although the country needs huge infrastructure improvements, the government is spending only about 2% of its funds on infrastructure. As a comparison, emerging markets in general are spending about 5%, with China as an outlier at 10%. Additionally, Brazil spends 5% of GDP on pensions for civil servants, more than twice the amount of infrastructure spending.

The issues cited above are unlikely to improve quickly. Reforms are implemented slowly in Brazil and oftentimes favoritism and vested interests keep the country from implementing the changes needed. Infrastructure spending 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. Many regulatory hindrances remain in place; as the World Bank reports, it takes an average of 119 days to set up a business in Brazil, the fifth longest period in the world.

Another public grievance is widespread corruption. Most recently, two people confessed to being part of a corruption ring involving the state oil company, Petrobras. Allegedly, 3% of the company's budget finances corruption. Some observers claim that corruption has become institutionalized under the current government.

Rousseff

Dilma Rousseff is the incumbent presidential candidate for the Workers' Party. She 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 under the regime. She is 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 to join the Workers' Party. She became the energy minister before running for president in 2010.

She has gained popularity during her presidency for lowering energy and food tax rates. In the beginning of her presidency, the country benefited from rising Chinese demand for Brazilian commodities and rising prices for those commodities. This allowed the government to increase public spending without addressing economic inefficiencies. The slower global growth environment has now surfaced these inefficiencies and discontent among her constituents. Corruption, slow growth and inflation are only some of the concerns. At the same time, unemployment has trended lower, maintaining support for Rousseff.

Neves

Aecio Neves is the presidential candidate for the Brazilian Social Democracy Party. He is an economist by training, and was the governor of the Minas Gerais region for seven years before being elected to represent the region in the Brazilian Federal Senate. His grandfather was elected president but died before taking office. Rousseff's campaign has used Neves' family background to accuse him of favoring the political elite at the expense of the working class. However, it does not appear that he has done so during his political career.

As governor, Neves introduced reforms to balance the local government's budget, known as the "Management Shock" program, which was aimed at reducing government spending and improving the quality of services and productivity of state institutions. Neves also promoted private investment, especially in infrastructure. On the education front, he initiated a program to boost high school graduation rates.

As president, Neves has promised to address corruption, introduce fiscal responsibility and design policies to control inflation.

Ramifications

None of the limitations that hamper Brazil's economy can be removed in the near term, no matter which candidate is in office. In the short run, however, the outcome of the presidential election will signal the country's willingness to reform and become fiscally responsible and politically transparent, which will determine the direction and strength of capital flows. If Neves wins, capital inflows would increase in anticipation of economic reform. Brazilian markets rose after a poll showed that Rousseff and Neves are now tied in the runoff elections, whereas Neves had lagged in prior polls.

Brazil faces economic difficulties that are related to its dependency on commodities and manufacturing weaknesses, especially in a slower global growth environment. For foreign investors, Brazilian domestic economic indicators are just as important as the strength of the economies that import Brazilian commodities, especially China. If the Chinese economy is slowing, we are likely to see a disproportionately larger deceleration in Brazilian economic growth. For these reasons, Brazil is often referred to as the "end of the whip" in global economic growth. On the other hand, if the Chinese government decides to pursue further investment growth, we could see limited strength in the Brazilian economy. However, given the global inventory overhang of industrial metals and oil, the boost in growth could be delayed. Lacking significantly stronger commodity demand from China, Brazilian commodity exports are likely to remain subdued.

Domestically, controlling inflation and continuing social welfare programs are key priorities in avoiding social unrest. Rousseff has used social spending to placate dissatisfaction, but if the government is serious about getting its spending under control then these social programs may have to be reduced and thus cannot be used to pacify the masses. If Neves wins, we could see increasing instability from the region if the country moves to limit its social programs. Additionally, if government subsidies for fuel and electricity are cut, inflation could rise further. If inflation picks up, a foreign investor should pay close attention to the central bank's response. Tightening monetary policy could constrain economic growth in the already weak manufacturing sector.

Corruption has also soared under Rousseff, a practice which Neves has promised to tackle. This could introduce further social instability. Thus, we could see increased geopolitical risk from the region under Neves as the country moves to reform itself.

At the same time, under the incumbent Rousseff, reform and possible social unrest would likely be delayed as she would continue her social policies. We would see further capital outflows from the country under Rousseff as foreign investors might fear that Brazil will follow in Argentina's path.

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