J O Hambro Capital Management Group

EMERGING MARKETS SPOTLIGHT

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- In Brazil, tension between parts of the corporate sector and President Bolsonaro's government have led to more decisive action by the government
- These moves show a clear move by the administration away from liberalising economic reforms and towards a more populist stance ahead of the 2022 elections
- However, it is important not to be too bearish; policy has to be viewed through the lens of fundamentals and, by our reckoning, the fundamentals look very good indeed

JOHCM Global Emerging Markets Opportunities Fund

In Brazil, several weeks of increasing tension between parts of the corporate sector and President Bolsonaro's government have led to more decisive action by the government. Most coverage has focused on the decision to replace the CEO of oil company Petrobras (held in the portfolio) after the company decided to increase petrol and diesel prices in line with crude oil prices in the face of government criticism. President Bolsonaro has instead suggested that the company should cut fuel prices by 10%. This management change has been poorly received by investors, as it both reduces headline profitability and also calls the outgoing CEO's shareholder-friendly operational and financial strategies into question.

This trend is not Petrobras-specific, though. President Bolsonaro is also pushing utility companies to reduce electricity prices. In addition, one of the major Brazilian banks, Banco do Brasil, has been under serious pressure to abandon its plans to rationalise its workforce. Taken in the whole, these moves show a clear move by the administration away from liberalising economic reforms and towards a more populist stance ahead of the 2022 elections.

This has a number of implications for investors. Coming at a time of rising US bond yields, the effect on the share prices of the companies concerned has been significantly negative, but at a wider level the stock market, local currency bonds and the currency have sold off and Brazilian CDS have increased.

This is partly because of the potential implications for fiscal and monetary policy. As the Brazilian economy normalises post-Covid, the question as to how to (or even, whether to) end the worsening drift in the trajectory of public debt becomes more urgent. There is a substantial domestic lobby arguing for prioritising economic support, and it is now more likely that President Bolsonaro will move in this direction. The key question for fixed income investors is the future of the fiscal spending cap.

The cap (given constitutional status in 2016) limits nominal growth in the primary (ex-debt interest costs) deficit to the rate of inflation. This would, over time, reduce the deficit as a proportion of GDP, and its existence anchors Brazil's fiscal policy and contains bond yields.

During 2020, with serious pressure on government finances, the government was able to avoid the cap through using a parallel 'emergency budget' for stimulus on the basis of a national emergency. As that justification passes, pressure to return to a fiscal stance that complies with the cap will conflict with popular (and hence political) pressure to remain fiscally loose. As we head into an election campaign, markets may assume that the spending cap will be abandoned.

As fiscally loose, so monetarily tight. The BCB, the central bank, meets in mid-March, and the reaction function of the bank suggests that a weaker currency and higher bond yields are likely to lead to a hike. This isn't a given, and consensus narrowly expects a hold in the meeting, but risks have definitely increased. The old adage that elections are good for markets in emerging Asia but bad in Latin America may yet apply.

And yet, it is important not to be too bearish. Policy has to be viewed through the

lens of fundamentals and, by our reckoning, fundamentals look very, very good indeed.

Barring a prolonged inflationary spike (end of December unemployment was 14.2%, pretty much the highest it has been in twenty years of data; capacity utilisation recovered to 80.5% in January, well below the 83-84% levels seen at cyclical peaks), Brazil's enduring weakness is its balance of payments, which is in turn largely a reflection of trade-related and portfolio flows.

And, right now, both of those look great. Brazil terms of trade (the ratio of export prices to import prices) are by far the best they have been in 25 years of data, far above the mid-90s or late 00s peaks. A year ago, soybean spot prices were BRL 40/bushel; that's now BRL 84. Iron ore has moved from BRL 380/t to BRL 900/t; sugar has gone from BRL 0.67/lb to BRL 0.92/lb. This feeds right through to the trade balance. Through 2015 and 2016, the Brazilian trade balance moved substantially into surplus with exports rising and import compression. 2020 saw volatility in trade flows as Covid-19 hit both domestic and external demand, and the last few months have seen economic recovery lift imports. However, there is a close historical relationship between terms of trade and exports, and that points to a substantial lift in exports as we move through 2021. At the same time, the non-goods component of the current account has compressed to a deficit of 1.4% of GDP compared with deficits of around 4% at cyclical peaks.

Portfolio flows are another driver both of the Brazilian economy and Brazilian financial markets. Mid-2020 saw large capital outflows from many riskier emerging markets, particularly from Brazil. Foreign holdings of Brazilian government debt fell from USD 140bn at the start of 2020 to USD 101bn in April of that year. The end of 2020, however, saw strong capital inflows with a better cyclical outlook and a weaker dollar. International portfolio flows into Brazilian government debt were US$16bn in Q4 2020, with half of that coming in December. Anecdotal information suggests a continuation of that in January and February, and also a similar pattern in the Brazilian equity market (where trading volumes have shot up in the last year).

Foreign direct investment (FDI) is perhaps the laggard. Net FDI into Brazil was down 50% in 2020 compared with the year earlier. The main trend within it is a reduction in large investment flows into sectors like autos and steel and a pick-up in much smaller flows into sectors like fintech and education. History would suggest that a sustained recovery will attract inflows, but the negative impact of President Bolsonaro's actions must be noted.

Concerns around politics and policy have meant that we have been cautious about adding exposure to Brazil, and we will continue to look to add opportunistically while the macro environment remains so supportive. It remains our view that Brazil is a market best seen as offering cyclical opportunities rather than a long-term buy-and-hold case, but there will be periods where the cyclical opportunity is strong and we believe that 2021 is likely to be one of them. The move higher in bond yields, reflecting a stronger global economy, is having a drag on Brazilian financial markets in the short-term, but that doesn't remove the strong fundamental case for the medium-term.

JOHCM Global Emerging Markets Opportunities Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	28.02.21	29.02.20	28.02.19	28.02.18	28.02.17
A USD Class	31.82	-1.04	-7.75	27.18	28.36
Benchmark	35.99	-2.14	-9.77	30.52	30.44
Relative return	-3.07	1.12	2.25	-2.56	-1.59

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 28 February 2021. The A USD Class was launched on 30 June 2011. Benchmark: MSCI Emerging Markets NR (12pm adjusted). Performance of other share classes may vary and is available on request.

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