JOHCM Funds

Emerging Markets Spotlight

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"Settle down, calm down — a change is taking place in the country"
Mexican President-elect Andres Manuel Lopez Obrador, October 30, 2018

The global environment continues to pose challenges for emerging markets, with tight US dollar liquidity, a slowdown in China and stresses about the global trade system all acting as headwinds. However, emerging markets will continue to also be driven by country-specific factors, very much including changes in the outlook for politics and governance, and this has very much been the case in both Brazil and Mexico in the last few weeks.

In Brazil, the political order has been shaken by the election as president of the right-wing populist Jair Bolsanaro, who stood on a platform of generally liberal economic policies and illiberal social policies. His economic policy ambitions include proposals to reduce both state spending and state intervention in the economy, although he has sent mixed messages regarding the privatisation of large state-owned companies such as oil producer Petrobras and electricity utility Eletrobras. The prospect of the adoption of these policies has been well-received by financial markets.

As followers of our views will be aware, though, we believe that the critical policy measure for Brazil is pension reform. It is generally accepted that Brazil needs to run a primary fiscal surplus (i.e. before paying interest on government debt) to achieve economic stability. Brazil has been running a primary deficit since 2014, largely because of uncontrolled growth in social security expenses, the majority of which is related to pensions. As an example, 10 years ago, in September 2008, the Brazilian federal government had revenues of BRL 50.7bn, expenses of BRL 44.6bn (of which BRL 20.9bn were for social security), a primary surplus of BRL 6.1bn and interest costs of BRL 4.1bn. Ten years later, revenues have grown to BRL 96.7bn, but expenses to BRL 119.6bn, with BRL 61.5bn of that being social security costs, leaving a primary deficit of BRL 22.9bn before interest costs estimated at BRL 49.2bn for the month. We believe that for Brazil to avoid a fully-fledged sovereign debt crisis, the social security system must be reformed within the next few years.

To do this, President-elect Bolsonaro must get a reform bill approved by a three-fifths super majority twice in each of the chambers of Congress. In the lower house, that requires at least 308 votes of the 513 members. Whilst more right-wing parties did well in the Congressional election, it will be very difficult to pass pension reforms, particularly if illiberal social policies alienate more centrist politicians. We remain in a wait-and-see mode on Brazil, with the portfolio holding a small underweight position relative to benchmark.

Mexico, meanwhile, has seen financial markets react negatively to one of the first major policy steps of President-elect Andres Manuel Lopez Obrador (known as AMLO), which will be to cancel the controversial new airport for Mexico City. The decision, legitimised by a chaotic referendum, has been taken particularly badly by bond markets (where US$6bn of airport bonds are now at risk), with a concurrent sell-off in equity markets. Investors are particularly concerned that the AMLO administration will continue to enact populist policies via direct democracy.

Returning to the global environment, though, we continue to find a lot to like about Mexico. Mexico exports US$300bn of goods and services to the US, 81% of its total exports, and is also a beneficiary of the strong US economy through remittances (about US$28 billion in 2017, the vast majority of which came from the US). The renegotiation of NAFTA removes key risks to the Mexican economy, while Mexico is among the few emerging markets to be a net oil exporter. As with Brazil, we remain in wait-and-see mode, with a broadly neutral position relative to the benchmark, but do wonder if Mexico will prove the better medium-term investment.

Source: Bloomberg

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Data sourced from JOHCM/Bloomberg unless otherwise specified.