GRANT'S
INTEREST RATE OBSERVER®

Vol. 36, No.01f Two Wall Street, New York, New York 10005 • www.grantspub.com JANUARY 12, 2018

Divine currency call

Number one on *The Economist*'s list of the world's currencies (the sovereign kind) stands the real. On the authority of the paper's Big Mac Index of purchasing-power parity, the Brazilian scrip is 56.9% overvalued vis-à-vis the dollar, tops, if that's the word, among 36 global entrants. If the following analysis is on the beam, the airborne real—along with the ascendant Ibovespa stock index and the elevated real-denominated bond market—are destined to come fluttering back down to Earth.

Brazil, the world's fifth-largest country both in land mass and population, makes its considerable presence felt in world trade (as a commodity exporter), world investing (as a fixture in emerging-market stock and bond indices) and world borrowing (its companies are second only to China's in their issuance of external U.S. dollar debt). As the world is, for the moment, head-over-heels bullish on everything EM, so does it love Brazil.

The world has its reasons, and they may have merit—writing from frozen lower Manhattan, we won't dogmatize. We only say that the bulls make no allowance for chance or Murphy's Law. A full-fledged bull on the Great Green country must believe most or all of the following:

– In February, the Brazilian Congress will pass a hugely unpopular social-security reform (a November poll showed only 12% in favor).

– In October, the Brazilian people will elect a center-right proponent of free-market economics (though the crooked, beloved Lula leads in the polls).

– A rumored imminent downgrade of Brazilian sovereign debt into the deeper realms of junk is only a rumor.

– The SELIC, Brazil's overnight central-bank-administered rate, will remain near 7%, the all-time low.

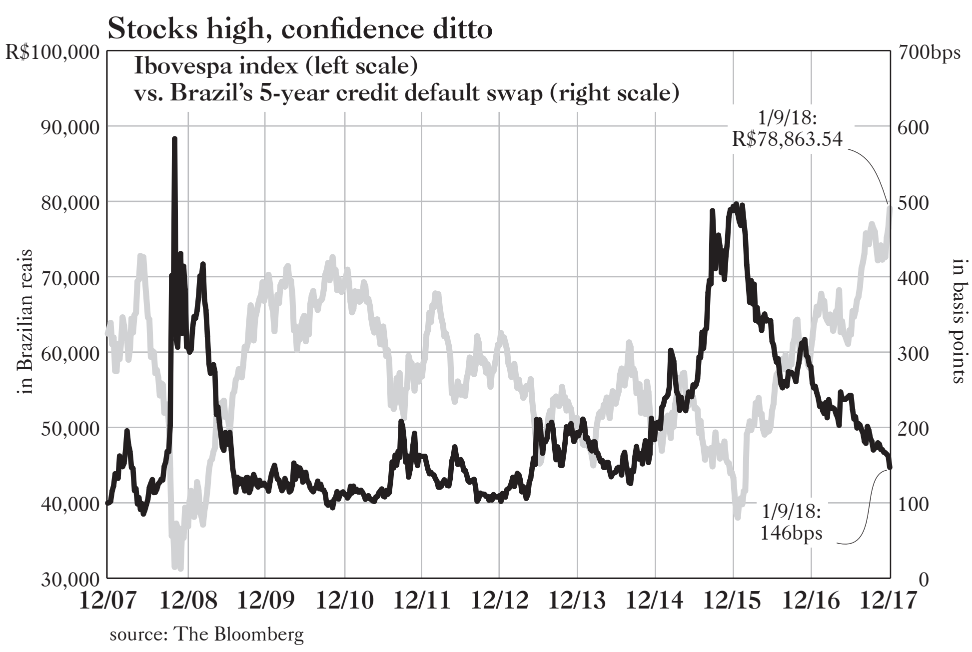
– The notoriously volatile Brazilian CPI will hold in the neighborhood of 4%, down from 10.67% as recently as 2015.

– The Brazilian economy, following two consecutive years of recession in 2015 and 2016—the first such back-to-back contraction since 1930–31—will build on the tepid 2017 recovery to register growth of 2.7% in 2018.

– Murphy's Law will work in reverse: Anything that can go right, will.

Of course, from an investment standpoint, much has already gone right, and rising asset values create their own reality ("markets make opinions," quoth the late, great Richard Russell). After rallying by 9.3% in 2016, the iShares JP Morgan USD Emerging Markets Bond ETF (EMB on the Big Board's Arca Exchange) climbed by 10% last year, handily beating the 6.1% run by the iShares iBoxx High Yield Corporate Bond ETF (HYG, also on NYSE Arca). To judge by the $231 million inflow into the EMB on the first trading day of 2018, the market is banking on more of the same this year.

In Brazil, it started with the New Year's rally in the Petrobras 6.85s of 2115, the century dollar bond that came to market in 2015 at an offering price of



source: The Bloomberg

81 to yield 8.45%. What would you have bet that those (oversubscribed) securities would ever reach par? We would have bet against it, even at the day of their maturity. Well, they did it, in fact, on Jan. 3, with a three-point leap to 100.

Few would deny that Brazil deserves a break after years of economic dysfunction, nonstop revelations about the turpitude of the Brazilian political class and steady fiscal backsliding. Mr. Market himself, obviously, is sympathetic. Since the January 2016 stock-market low, the Ibovespa index has climbed by 110% (169% in dollars). And since the September 2015 real-dollar exchange-rate low, the currency pair has strengthened to R$3.25 from R$4.17.

Were it ought not to be

source: The Bloomberg

"The Brazilian market is driven by consensual thinking," a Brazil-born head of fixed income and derivatives trading at a New York-based brokerage firm tells colleague Fabiano Santin, who himself was born in Brazil, speaks and writes Portuguese and who, before joining *Grant's*, worked in the money-management business in Rio de Janeiro and São Paulo. "Investors are tired of the long recession and seem anesthetized by market rally in the past two years."

Which, Santin adds, is no good reason to expect more of the same in year three. "Investment folk, hoping for mean reversion, ought to be careful about betting on a strong rebound," he says. "Brazil's potential growth is limited by years of under-investment in infrastructure. The country's fixed capital formation has averaged around 18.6% of GDP in the past 15 years, much lower than the average 22.1% invested by Latin American peers Chile, Colombia and Mexico. The low level of investment translates into low productivity—and vulnerability to energy crises. Brazil's energy production is largely hydroelectric (65% of installed capacity). In October, reservoirs registered their lowest water levels since record-keeping began in 2000. The rains did fall late last year, boosting storage levels to 25% from the autumn low of 17%, but how do you plan for rainfall (or the lack of it)?"

Another constraint on Brazilian growth is its constitution. Now in its seventh edition since national independence from Portugal in 1822, the parchment runs to 64,488 words, counting 99 amendments, almost two-thirds the length of a standard trade nonfiction book. In verbosity, it lags only India (146,385) and Nigeria (66,263), according to a 190-country survey by the Comparative Constitutions Project. While a rambling constitution hardly rules out buoyant asset markets (India had a stellar 2017), it does point to a penchant for governmental micromanagement.

Such control gives rise to rent-seeking, and rent-seeking to corruption. In Brazil, corruption gave rise to "Operation Car Wash." What began as a probe into a small-time money-laundering scheme at a Brasilia gas station has grown like Pinocchio's nose. Investigators to date have uncovered $5 billion in nefarious payments among and between state companies, private companies and elected officials.

Following the money, the authorities ran into none other than Luiz Inácio Lula da Silva, elementary-school dropout, metallurgical worker, union leader and, between 2003 and 2010, Brazil's head of state. How President Lula came to possess a fancy triplex in a beachfront high-rise apartment building during his term in office is a mystery that a first-instance court provisionally solved when it sentenced the 35th president to nine-and-a-half years in jail for accepting graft. An appellate court is expected to review the decision on Jan. 24. Delays attendant on further appeal may buy Lula enough time to permit him to enter the October presidential election. In handicapping his odds for a sympathetic hearing sometime later in the appellate process, it helps to recall that 7 of the 15 judges on Brazil's Supreme Court owe their spots on the bench either to Lula or to his successor, Dilma Rousseff, who was impeached and removed from office in 2016.

As of now, according to a December Datafolha poll, Lula is in front with 34% of the hypothetical vote, followed by Jair Bolsonaro, a former Brazilian Army captain, who likens himself to Donald Trump. Neither populist is a champion of Adam Smith, though, in Lula's case, you could understand if the voters had decided that he *is* Adam Smith, so prosperous was the country under his administration.

"He was blessed with lively growth, a weakening dollar (i.e., a strengthening real, which kept inflation in check), high commodity prices and a debt expansion the likes of which, both domestically and internationally, the world had rarely, if ever, seen before," Santin points out. "Local credit in the private nonfinancial sector grew to 52.8% of GDP in 2010, at the end of his term, from 30.3% in 2002, the year before he took office. During Lula's tenure, the Brazilian economy grew at an average rate of 4.1% a year, not quite up to the mark of Chile, Argentina, Peru or Colombia, but impressive nonetheless. Certainly, it outshines the record of his successors."

That record shines brightest if you ignore the national balance sheet—which the rating agencies, at least, seem not inclined to do. The current double-B rating, in place since 2016, is at risk of a single-notch downgrade. The ratio of debt to GDP reached 74.4% in November, from 51.5% in 2013, and the central bank projects a leap to 80% by the end of 2018. The fiscal good intentions of the government of Michel Temer are proving no match for automatically rising social-security expenses and inflation-indexed entitlements.

"Despite a relatively young population (the old-age dependency ratio is half the Organization for Economic Cooperation and Development average)," Santin notes, "Brazil's social-security budget shortfall will have reached 4.5% of GDP in 2017, up from 4.1% in 2016 and 2.8% in 2015. Population aged 65 and older is projected to grow by 4% a year for the next 20 years, rising to 38% of all Brazilians by 2050, from 7.6% in 2010. The actuarial deficit (the excess of the present value of projected future benefit obligations over contributions) already is closing in on 150% of GDP—compare that with 61% for America's social-security system."

A test of political will awaits next month when the National Congress of Brazil is slated to vote on a constitutional amendment to boost retirement ages and raise required social-security contributions. Passage is uncertain—the Temer government, which is sponsoring the measure, postponed its consideration late last year to try to corral the necessary votes. It's not even clear that, if the amendment did pass, it would achieve much more than to stabilize a very large problem. As for the Brazilian people, a November poll showed 69% wanted no part of the plan to labor longer and pay more. The government has its work cut out in any case. Because social-security benefits are enshrined in the constitution, three-fifths of the not-invariably-courageous solons must vote to change them.

You could not infer that much is wrong by a glance at Brazil's financial vital signs. The country's 10-year U.S. dollar-pay sovereign debt changes hands at a spread of just 192 basis points to the 10-year U.S. Treasury, the lowest reading since 2014. The cost to insure against a Brazilian state default (via a five-year credit-default swap) stands at 146 basis points—again, lowest since 2014; on the eve of Rousseff's impeachment, the cost of protection was 500 basis points. And Brazil's five-year inflation-linked security delivers a real yield of less than 5%, down from 7% in early 2016. Where else in the world, bulls demand, can you find such bounty?

We bears, including Marcelo Lopez, founder and portfolio manager of Brazil-based L2 Capital Partners, have a reply. The currency is the principal chink in the Brazilian armor. "You have to look at the level that the real is trading at," says Lopez. "For us, the real should be lower, because we think that Brazil will be downgraded. The government won't be able to control the primary deficit; even the social-security reform won't have a major impact. Even if they pass this [reform], the primary budget will stay in the red. It may get less worse in the red, but it will stay in the red. . . . And more, I think that if there is a small problem in the world, the country could suffer a lot. And there is no shortage of world problems. The real trading at these levels must be God giving an opportunity to Brazilians who still have too much real exposure to trade them for dollars, because this level doesn't make any sense to us."

On form, the real-dollar exchange rate is no kind of one-way trade. In inflation-adjusted terms, the Brazilian unit lost 40% from 2011 to 2015, the consequence of a rising CPI, a slowing economy (with deteriorating fiscal balances), weak commodity prices and political scandal. The decline and fall (and defenestration) of Dilma Rousseff restored confidence, and the real-dollar pair leapt by 30% from January 2016 to today.

Not a little of the enormous rally in all things Brazilian can be put down to good luck. Brazil's lowest-ever interest rates are owing to low inflation. Low inflation, in turn, is owing in good part to salubrious weather and bumper harvests. Meanwhile, low local interest rates (which are getting relatively lower thanks to more-stringent Federal Reserve policy) make the currency less attractive, both absolutely and relatively. As the October elections draw nearer, investors may not like the looks of the polls. To register this prospective disapproval, they may begin to take God's hint on the overvalued real.

"This may prove the most open-ended, cliff-hanging election since 1989," Santin comments, "and the uncertainty seems not yet (as they say) 'priced in.' Even if a market-friendly president won, he would still need congressional support to push through constitutional reforms. In other words, if the real is going to continue to hold its own, much less appreciate, in 2018, the market needs a center-right candidate to win the presidential election, a supportive congress to win beside him, no external shocks and an economy that grows by at least 2½% per annum over the next two years. It's a lot to ask—and the trouble is that the market is priced as if it had already happened."

Much has changed in the 15 years since Lula took over and rode the early 2000s bubble to fame and, prosecutors allege, fortune. Some things remain the same. Corruption was rampant then; Car Wash proved that it was worse than even the most cynical Brazilian imagined. Possibly, it is no less rampant today. At least, the lax Brazilian penal code constitutes no real check to wrongdoing. Fifteen years ago, the government's primary budget showed a 3.5% surplus; today, there is a 2.8% deficit. A decade and a half ago, the greatest central-bank-led credit expansion was still off in the future. Today, it's in the past. Then, the SELIC rate stood at 19% and inflation-adjusted interest rates at 12%. Today, a 7% SELIC delivers an inflation-adjusted 3%. After making allowances for the cost of living, the real was quoted at R$6.62 to the dollar when Lula came to power. Now, it trades at R$3.25.

Understandably, perhaps, Lula does not want to go to jail (though there is something to be said for the amenities of Brazilian incarceration). Inexplicably, he wants to repeat as president of a systematically overvalued country. *Grant's Interest Rate Observer* suggests that he reconsider.

•