Brazil Watch

Group Economics
Emerging Markets Research

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The winner takes it all

- **Extreme right populist Bolsonaro becomes the next president**
- **While political uncertainty will diminish, polarisation will rise**
- **Confidence rise will probably not last**
- **For now, we stick to our 2018/19 growth forecasts of 1.5% and 2.5%.**

Jair Bolsonaro defeats Haddad in second round with 55% against 45%

As expected, the extreme right wing Jair Bolsonaro won the second round as candidate of the PSL and will become Brazil's next president in January. The public discontent with corruption, traditional politics and especially with the leftist labour party PT formed the basis of his victory. Bolsonaro will follow up president Temer of the right wing PMDB, who became president after the impeachment of the last elected president Dilma Rousseff of the PT. The impeachment of Rousseff on charges of fiscal irregularities brought an end to 13 years of leftist rule. While it started successfully under the eight years government of president Lula, the situation deteriorated when Rousseff succeeded Lula and got worse after the collapse of commodity prices in 2014. The severe corruption scandal known as Lava Jato (car wash), which burst out into the public at the start of 2014 did not help either. The scandal centered around the state oil company Petrobras and the construction firm Odebrecht and led to the imprisonment of over hundred politicians from the entire political spectrum, including in April of this year the still highly popular Lula. Until the last moment Lula aimed at running for president, but he was finally barred from running by the Superior Electoral Court under the Clean Slate law. Fernando Haddad, former mayor of Sao Paulo then became the PT candidate.

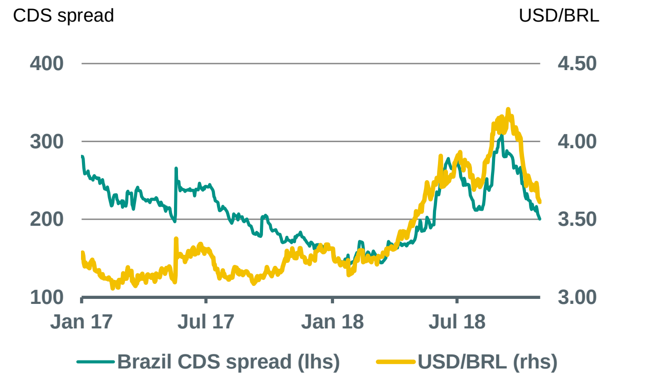
Barring Lula from running opened the way for the former army captain Jair Bolsonaro to win the elections. Until recently Jair Bolsonaro was a relative outsider, with little achievements in his 26 years as a parliamentarian for different right wing political parties and with no executive experience at all. In the first round of voting it became clear how fed up the electorate was with the with corruption associated traditional parties. The more moderate right wing candidates like Geraldo Alckmin of the PSDB barely got any votes, while Bolsonaro with a share of 46% almost got enough votes to win already in the first round.

The end of the election process alone will at least bring some tranquillity to the markets, but if this will last remains the question. Polarisation will most likely rise, and bouts of social discontent might increasingly lead to rising repression, which eventually will weigh on the investment climate.

Further recovery of the real for now until optimism fades

In the period January 2018 until the end of August 2018, the Brazilian real lost more than 25%. Fear of an escalating trade war between the US and China, higher US dollar, higher US yields and political uncertainty in a numbers of emerging markets were the main reasons behind this weakness. Since then it has recovered remarkably (by 13%). The main reason has been lower election uncertainty because of a high probability that Jair Bolsonaro would become the next president. Investors have high hopes that he would bring the necessary changes. We remain more sceptical (see above). In the near-term, it is likely that the real will rise further especially as it has taken out an important technical resistance level. However, when the optimism fades we think that the real will give back some of its recent gains. We keep our year-end target of USD/BRL at 3.7. For next year we expect a further strengthening of the real mainly because of a weaker US dollar, lower US Treasury yields and a more favourable environment for emerging markets. We maintain our end of 2019 forecast for USD/BRL at 3.2.

Lower perceived political risks boost real



Source: Bloomberg

Favourable market reaction might not last

Markets reacted favourably on the prospect of a continuation of a liberal economic agenda. Confidence levels are expected to rise and given a still favourable global environment delayed investments might pick up stronger than would have happened if Haddad had won the elections. Still, eventually tackling the deplorable state of the public finances will be what matters to maintain confidence. The stubbornly high budget deficit of around 8% of GDP and a public debt of almost 80% of GDP leaves a new government no choice than fiscal austerity. While Bolsonaro has pledged to continue with the pension reform which president Temer failed to get approved, it will most likely be further watered down. In an atmosphere of widening polarisation, it may be more difficult than ever to build the coalition necessary to achieve the required two-thirds majority for the fiscal reform programme. Promises of more privatisation might fill part of the gap, but the risk is that selling some of the *crown jewels* could lead to discontent with his nationalistic base. It therefore remains to be seen if under Bolsonaro the fiscal situation will improve as much as markets seem to hope for. For now, we assume that the new government will continue the reform process, but that any progress will be sluggish. The primary budget (i.e. the budget before interest payments) will therefore remain negative for the time being, while a surplus is needed to lower the government debt level. If the public finances continue to deteriorate over a longer period of time with no sign of debt stabilisation, the country will very probably face yet another credit rating downgrade.

External headwinds also pose a threat to the economic growth outlook
Monetary policy normalisation in the US, fears of rising protectionism and political/geopolitical tensions have lately caused significant turbulence in emerging markets in recent months and turbulence can easily flare up again and impede a strong recovery of investments. It also limits the scope for a continuation of the relatively loose monetary stance. We therefore believe that economic growth will remain moderate at best and stick to our earlier forecast of 1.5% growth in 2018 and 2.5% in 2019.

Key forecasts for the economy of Brazil

	2015	2016	2017	2018e	2019e
GDP (% yoy)	-3.5	-3.5	1.0	1.5	2.5
CPI inflation (% yoy)	9.0	8.7	3.4	3.8	4.2
CPI Inflation (% eoy)	10.7	6.3	2.9	4.5	4.0
Budget balance (% GDP)	-8.2	-6.5	-8.0	-7.0	-5.5
Government debt (% GDP)	66	70	74	79	84
Current account (% GDP)	-3.3	-1.3	-0.5	-0.5	-2.0
Gross fixed investment (% GDP)	18	16	16	16	17
Gross national savings (% GDP)	14	14	15	14	15
USD/BRL (eop)	3.90	3.26	3.31	3.7	3.2
EUR/BRL (eop)	4.24	3.44	3.97	4.3	4.0

Economic growth, budget balance, current account balance for 2018 and 19 are rounded figures
Source: EIU, ABN AMRO Group Economics