A Pivotal Change in Brazil

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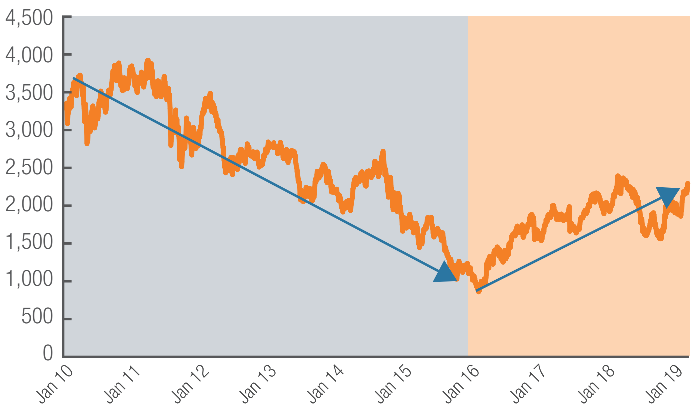
What Happened?

Brazil is in the early stages of a potential structural change, which has set the stage for a market-friendly investment environment. After a 5 year collapse when Brazilian equities fell roughly 73% between 2011 and 2016,[1] the MSCI Brazil Index has since rallied about 88% through year-end 2018.[2]

14 years under Brazil's PT (Worker's Party) government led to investment challenges such as a growing fiscal deficit (approximately 10% of GDP), the use of State funds to create "national champion" companies that challenged the concept of free trade and capitalism, an increasing legacy of protectionism, a lack of central bank autonomy, and one of the largest corruptions schemes in global history ("Lavo Jato").

These challenges led to negative GDP growth, higher public debt and thus an increase in country-risk, which, together with a decline in commodity prices, weakened the country's currency. The Brazilian real (BRL) moved from a peak of BRL1.54/USD to above BRL4/USD between 2011 and 2015, which led to a spike in inflation and put pressure on the central bank to raise interest rates, creating additional hindrance on growth.

Chart 1: Brazilian Equities Rebound

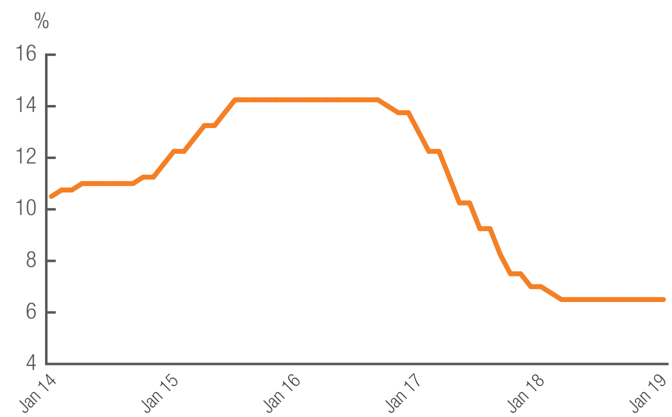


Source: Bloomberg. As of 1/31/19.

What Changed?

Prospects for political change increased with Lavo Jato and the 2016 impeachment of President Dilma Rousseff. Global investors saw an opportunity to invest in a country paying a 14.25% base rate, a seemingly more independent central bank, a powerful judiciary system, and a new government focused on fiscal reform. This brought a wave of foreign direct investment, which strengthened the currency and led to lower inflation (especially in the low growth environment), allowing the central bank to cut interest rates 725 basis points since November 2016.

Chart 2: Brazil's Declining Interest Rate Policy



Source: Bloomberg. Based on Brazil's Selic Rate. As of 1/31/19.

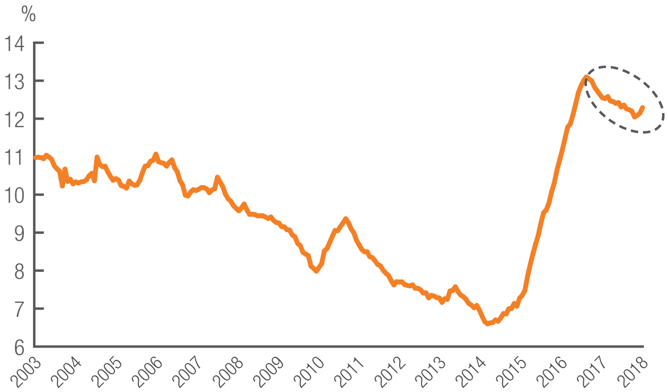
[1]Bloomberg, MSCI Brazil Index (USD), based on cumulative results from 12/31/2010 to 12/31/2015.
[2]Bloomberg, MSCI Brazil Index (USD), based on cumulative results from 12/31/2015 to 12/31/2018.

Where Are We Now?

Despite this positive momentum, GDP growth remained tepid and unemployment hovered around 12%. Much of the stagnant environment was due to the market fearing a potential PT victory in the Fall 2018 presidential election. Now, with this risk behind us, and President Bolsonaro leading the executive branch with a market-friendly Finance Minister, investors are looking at a situation with low inflation rates, credible monetary policy, low capacity utilization rates, pent-up demand, and significant political catalysts in the form of social security reform, privatizations, and trade liberalization.

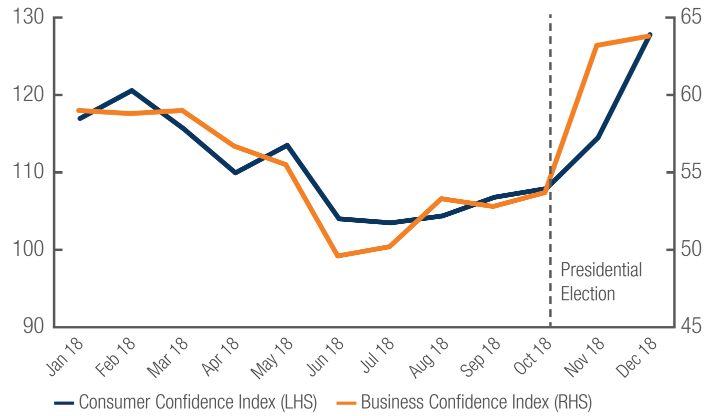
In the past few months, we have begun to see an improvement in consumer confidence, employment, and investment. Valuation multiples are still in-line with historical averages. If Brazil can move forward with the necessary reforms, firm up its fiscal deficit, and leverage the country's tremendous advantages in natural resources and demographics, Brazilian equities could be set for an attractive multi-year re-rating.

Chart 3: Unemployment in Brazil is Starting to Improve



Source: Itau Securities.

Chart 4: Prospects of Political Change Bring Confidence Back to Brazil



Source: Banco Central Do Brasil.

Consumer Confidence Index — varies between 0 (absolute pessimism) and 200 (absolute optimism).

Business Confidence Index — the parameters vary from 0 to 100. Any level above 50 indicates confidence by the entrepreneurs.

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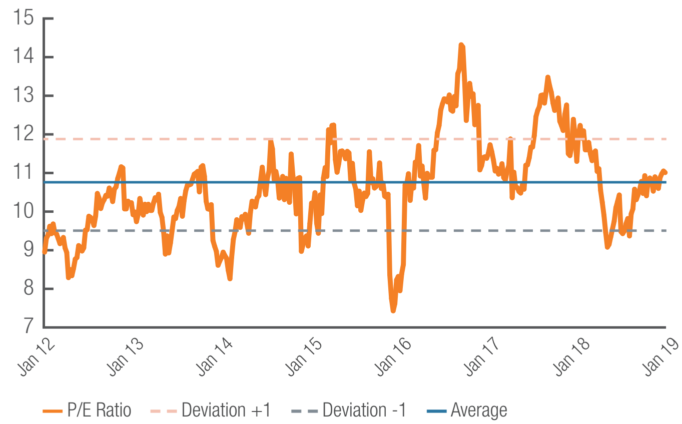
Chart 5: Brazilian Equities are Trading In-Line With Its 5-Year Historical Average



Source: Bloomberg. As of 1/31/19. Based on 2-Year Forward P/E.

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