BAILLIE GIFFORD | Emerging Markets

Emerging Markets – monthly insights

July 2023

In November 2022, our monthly commentary challenged the pervasive theory that Lula's re-election would be bad for the Brazilian economy. Our experience of investing in Brazil over the last 30 years has shown us that commodity prices are far more critical to equity markets than politics. However, since Lula took office at the start of the year, Brazilian equities have been on a tear, with much of this driven by an appreciating real. In this short monthly note, we'll cover what's been driving this and why we're still optimistic about what Brazil can deliver for the portfolio.

Previous periods of fiscal splurging have meant that Brazil has often had the highest public debt relative to GDP in Emerging Markets. This was the case in 2021 when that ratio reached 93% due to Covid handouts. However, with the help of strong commodity prices, Brazil's economy has been booming, and the relative position has significantly improved, with the ratio now at 73%. The understandable concern of many market commentators was that the re-election of the left-leaning former trade union boss would reverse this progress, triggering an onslaught of fiscal spending that would exacerbate Brazil's debt position. In stark contrast, Lula has backed "historic" reforms in the tax system, where it is estimated that the average Brazilian business takes a mind-numbing 1,500 hours to prepare its returns and pay its taxes. Previous attempts at reform have failed miserably, and whilst the legislation still must make its way through both houses of Congress, fears that Brazil's new president would be "anti-market" now appear overblown, and markets have responded accordingly.

It's also encouraging that inflation is well under control, having peaked at 11.7% in May 2022; it's now fallen to 3.2% as of June 2023. This suggests that the Brazilian Central Bank will begin a rate-cut cycle in the coming months and that Brazil is 'further ahead' than much of the rest of the world on this front. Cheaper access to capital is good for Brazilian companies, but lower rates should also support the capital markets, as domestic investors turn to equities to do the heavy lifting in their portfolios. This should provide a tailwind for the Brazilian stock exchange, B3, that we own on our clients' behalf. The longer-term outlook for this company remains exciting, as equity investors in the country are few and far between. In Brazil, 2% of the population invests directly in the stock market, whereas in China, it's 15%; in the UK, 30% and in the US, 57%.

The demographics of the country are also conducive to growth. Since the early 2000s, the government has channelled vast amounts of investment into the education sector. As a result, literacy rates have improved to 94%, well above the global average of 87%. There are still improvements to be made, particularly on how many students make it to university graduation, but the government looks set on change. This highly literate population now has information at their fingertips, as internet penetration has improved from 40% to 80% since 2010. This has paved the way for innovative companies like MercadoLibre to create life-changing services and generate value. The e-commerce and fintech business's rise has been nothing short of a miracle, but it's still early days. It's currently valued at $60bn, operating in a region twice the size of the US, and its website receives four times as much traffic as Amazon does in Latin America.

Brazil benefits from a high GDP share of commodity exports, and the country's best performance periods have coincided with a strong run-in essential commodities, particularly oil. Between May 2004 and May 2008, the price of crude increased from less than $40 a barrel to almost $140 a barrel, whilst MSCI Brazil increased by 650%, in dollar terms. So why do we believe oil prices will remain elevated, especially as the world transitions to cleaner energy? Despite global ambitions, we are still heavily reliant on "black gold". Demand is hitting new highs, with 102 million barrels a

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day predicted throughout 2023 and in the International Energy Agency's Stated Policy Scenario, oil demand is predicted to continue to grow until 2035. However, scenario analyses vary widely, which presents a problem for oil companies that would have typically capitalised large greenfield projects over multi-decade cashflow periods. As a result, the industry has focused spending on smaller, less capital-intensive, or modular projects with short payback periods. One company that has continued to grow production is Petrobras, the state-owned oil company. However, Lula's appointment spurred similar "anti-market" concerns, suggesting the business would be forced to engage in loss-making projects that benefitted the nation. However, the oil majors' profitability is crucial to tax revenue ($67bn in 2022) and GDP. In recent meetings with the company, management has made it clear that profitability is still front of mind, and in fact, CEO Jean Paul Prates has stated that "he's ready to be the world's last oil producer". But we are likely to see more capital directed towards profitable green investment. The company recently cut its dividend policy from 60% of free cash flow to 45% to allow for capital allocation. Even though the company boasts some of the lowest lifting costs outside of the middle east, it is a dividend machine (despite the recent cut), is growing production, and is planning for the future, it's still trading on just 2x earnings. The mind boggles, particularly against a global backdrop where global oil supply isn't increasing enough to meet this growing and sticky demand, with global rig counts still 10% below pre-Covid levels.

So where does this leave us? The history of Brazilian macro development would suggest that progress is rarely smooth and quite often completely non-existent (GDP in dollar terms is still roughly $1trn lower than it was in 2011!), so we are mindful of not getting carried away. However, we appear to be being compensated for the ongoing risks. Brazilian equities continue to trade at a significant discount to broader emerging markets and are half the price of developed markets. This still appears to undervalue the stabilising politics, pro-market policy, favourable demographics, under-penetrated markets, and favourable commodity outlook. So, for the time being, our overweight position is likely to persist.

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