

Brazil: Lula's trial to help clarify electability prospects

Brazil's former leader Luiz Inacio Lula da Silva may learn on Wednesday whether or not he can run for president again in October's elections. The ruling has key implications for markets



Former Brazilian president 'Lula' da Silva

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A definitive answer is unlikely

The conclusion of Wednesday's trial is bound to generate considerable market reaction but, unless Lula is acquitted, it is unlikely to provide a definitive answer about his legal status as a contender in the October presidential election. The result will serve instead for investors to recalibrate their assessment of Lula's real chances of running and, eventually, winning the race.

Lula has vowed to undo reforms

General Elections (October 7) will be a critical catalyst for Brazilian assets this year, and one of the most important questions investors have regarding the ballot could be decided, or at least become clearer, on Wednesday. The issue involves former President Lula's appeal to a corruption and money laundering case for which judge Sérgio Moro sentenced the former president to 9 ½ years in prison.

This is the most advanced of the several legal cases Lula faces and the only case that has reached a higher court, following a lower court conviction. According to Brazilian laws, if a conviction is confirmed by a higher court, an individual cannot run for elected office.

This is a critical question because Brazil's fiscal trajectory remains unanchored, and additional efforts are needed to avoid the consolidation of an explosive public debt trajectory. As a result, it would be critical to elect a candidate committed to fiscal austerity and to the reforms recently implemented by the Temer administration. But Lula, who continues to lead opinion polls, with about one-third of electoral support, has promised to undo these reforms and to end fiscal austerity, increasing the odds of an increasingly negative macro environment following the elections.

Despite what the law says, it is unlikely that Wednesday's trial will mark the end of the road for Lula's hope to get elected. In our base case scenario, even if Lula's conviction is upheld this week, the matter will not be definitively resolved until at least August, after Lula registers his candidacy, possibly on the last registration day (August 15), eventually forcing the Superior Electoral Court (TSE) to rule on the matter.

There is a possibility that the case of Lula's eligibility to run is litigated ahead of the registration of his candidacy, but local legal experts do not seem to hold a consensus on this matter.

So, does this week's result matter? YES. It is a necessary step to prevent Lula's candidacy. But the specific case about his eligibility may only be ruled AFTER he registers as a candidate.

How the market could react

We believe that market reaction will follow a basic assumption that the harsher the ruling against the former President, the weaker the chances that Lula's eventual appeals would succeed, helping consolidate the view that even if Lula continues to campaign (unofficially) and lead the polls, the former president will not appear on the ballot come October 7. This will be judged primarily on two dimensions: the degree of consensus among the three-judge panel and how the sentence compares with the original sentence of 9 ½ years in prison.

The ideal outcome for financial markets would be a consensus decision (i.e. 3x0) and a sentence that matches Moro's 9 ½ years. Even though a harsher sentence would, in principle, serve to intensify the gravity of Lula's situation, a longer sentence would actually delay the process by opening the door for the defendant to dispute it, delaying the hearings. Our best guess is that current market consensus incorporates the view that the former president will get an unfavourable but non-consensus ruling (ie. 2x1) on Wednesday. A non-consensus ruling also opens the door for an appeal at the same court, and could alter the final outcome with the introduction of three additional judges to the judging panel.

Alternatively, if the judges surprise by changing the guilty verdict and acquit the former president, local assets would come under severe selling pressure.

When will the issue be definitively settled?

There's no high-conviction answer to that question yet as lack of precedence and lack of clarity about the defence team's future actions prevent a clearer assessment. The former president's strategy involves exhausting all appeal options and taking advantage of all viable procedural

delays, including by delaying an eventual registration of his candidacy until the deadline (August 15), in hopes that by continuing to perform well in the polls, the courts would be pressured to accept his candidacy.

Depending on the verdict tomorrow, Lula can appeal the result at the same court (e.g. if there's no consensus among the three judges or the defendant asks for greater clarity about any element of the sentence). After that, Lula's team could try to press its case in higher courts (STF or STJ), but it is unclear if he would do that, as this could actually advance a potential ineligibility ruling. It is also unclear if those higher courts would accept the case but, in any case, unless they accept the case and provide the defendant with an injunction temporarily suspending rulings from the lower courts, the legal results so far would be sufficient to disqualify him as a candidate. A better strategy for the former president could perhaps involve bypassing the Supreme Federal Court/Supreme Court of Justice and just simply waiting until August 15 to register as a candidate and wait for the Superior Electoral Court (TSE) to rule on the matter.

This suggests that the question about Lula's ability to run may only be definitively settled after August 15, probably sometime in September, when we expect the TSE to finally be able to deny his candidacy. Until then, expect Lula to continue to play a critical role in electoral dynamics.

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