Brazil: Near-term optimism to prevail

The election of Jair Bolsonaro should boost investor sentiment and add material upside to local assets, amid market-friendly policy announcements over the next few weeks. We expect market optimism to be tested late in 1Q 2019, when doubts about Bolsonaro's ability to approve unpopular reforms should intensify

Source: Shutterstock

Anti-establishment wave is confirmed

Jair Bolsonaro, the right-leaning candidate that has run as an anti-corruption law-and-order candidate was elected the next president of Brazil.

Financial markets should react very favourably to the news, despite concerns about the candidate's perceived authoritarian tendencies and conservative moral stance. The press has been especially eager to insert Brazil into the "familiar narrative" of the "death of democracy", or the rise of "populist autocrats".

In our view, however, legitimate as that narrative may be elsewhere, Bolsonaro's victory is more of a regional phenomenon, akin to Lopez Obrador's victory in Mexico. In both instances, a convincing anti-corruption message, amid widespread evidence of corruption by the political class, resonated strongly with the majority of the population, resulting in a broad-based rejection of the political establishment.

Overall, we suspect these concerns will wind down after the elections, as the opposition's exploitation of the topic should lose traction while Bolsonaro should reinforce his commitment to democratic principles, and adopt a more centrist and consensus-building agenda.

Moreover, we are especially optimistic about the strength of Brazil's institutions, including the judiciary, Congress, the press and the impressive capacity of the society to mobilise. The well-established track record of strong institutional independence, as demonstrated, for instance, in the Carwash investigations and the peaceful and orderly impeachment of Dilma Rousseff, suggests to us that there are robust checks and balances in place to curb a president's ability to erode deep-rooted democratic tenets.

It should feel like a honeymoon ... for a while

Bolsonaro's embrace of a fiscally-conservative and market-friendly agenda is bound to trigger sufficient positive headline-risk to sustain the rally in the nearer term.

Positive policy announcements during the transition period should include greater clarity over the timing, prioritisation and content of the reform agenda. Much of the focus will be on social security reform, but tax reform and a robust pipeline of privatisations are also expected to be announced. In addition, any agreement with current Congressional leaders to kick-start the legislative agenda before year-end, i.e. before Bolsonaro takes office on January 1 could boost local assets.

Any progress in some of the initiatives that are already under debate in Congress, including social security reform, the formal independence of the central bank and the overhaul of the credit bureau system, would, for instance, likely be seen as evidence of a cooperative stance between the new administration and Congress.

Cabinet announcements could also be catalysts for market reaction, but it's widely expected that Paulo Guedes, a well-respected liberal economist, will head the economic team. The permanence of experienced Finance Ministry officials in the team, such as Mansueto Almeida and Ana Paula Vescovi, would also be very well-received by investors.

The USD/BRL should consolidate below 3.7 in the nearer-term, likely reaching 3.5, but we continue to see 3.7 as closer to "equilibrium" for the currency. In particular, doubts over the new administration's ability to approve unpopular fiscal austerity initiatives are bound to intensify, sooner or later, and weigh down local assets.

Bolsonaro's ability to deliver reforms is the key question now

We have strong conviction that Bolsonaro will prioritise the confidence-boosting fiscal reforms that Brazil urgently needs, as he actively campaigned on them, but we also have doubts about his ability to get them approved in Congress.

The election result leaves Bolsonaro with strong political capital and a mandate to implement reforms. Prospects for the eventual construction of a centre-right base in Congress are also favourable, especially if Bolsonaro agrees to share power in the legislative by, for instance, supporting the re-election of Rodrigo Maia as Lower House President.

Generally, investor concern reflects the fact that the new Congress is marked by a higher degree of party fragmentation, a remarkable number of political rookies, and a more diffuse power structure, as traditional parties have lost voter support. Having to negotiate with a greater number of parties could complicate governability, but the leadership vacuum could also boost Bolsonaro's political ability to shape Congress. Much will depend on his political capacity to forge stable new alliances.

Ultimately, it's still too soon to say that Brazil's fiscal accounts will be re-anchored, but we believe that the electoral results improved materially the country's fiscal outlook. Informal polls by the local press with newly-elected congressmen suggest that resistance to social security reform has fallen sharply, while the opposition is not big enough to block its approval.

More importantly, the new administration appears to understand the urgency and the stakes involved in the approval of social security reform, i.e. this reform is a pre-condition for fiscal sustainability and the economic recovery. Failure to approve it would inevitably create enough uncertainty to threaten governability and the administration's own survival. It may not be easy, but Bolsonaro should be able to persuade hesitant but, in principle, swayable Congressmen to support his legislative agenda.