LatAm Equity Strategy

What it takes to get Ibov to 135k

Investment Strategy

05 July 2023

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Latin America

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History suggests 10y real rates could continue to fall

Market rates generally decline before and after selic cuts start. (see: What happens during selic cuts in 9 charts). In the last three easing cycles, for every 100bp cut in the selic we saw a 40bp decline in 10y market real rates. In 2023, real rates fell 124bp. This represents only 30bp for every 100bp expected selic cut (according to BofAe, see details on page 2). Thus, in our view, real rates could decline an additional 50bp (with upside risks) to put this easing cycle in line with historicals (Exhibit 2).

Current level of real rates allows for Ibov upside

Historical P/E for Ibov ex-commodities associated with 5.2% (current) real rates is 18% higher than current 2024E P/E (Exhibit 1). On top of that, an extra 50bp decline in 10y real rates (to 4.7%) could potentially justify another 3% higher valuation by the end of the year. All in, we can rationalize 21% upside and P/E at 4% above hist avg (in term of 2024E) for Ibov ex-commodities by year-end. We expect the re-rating to be steeper for growth names, high beta and bond proxies (Exhibit 5). 2024 EPS estimates are a key risk. This supports our Ibov 2023 year-end target of 135k (13% upside from current levels).

Looking for accommodative valuations, not value traps

Despite the rally of the last 3M, some industries/names have accommodative valuations, especially if rates continue to fall (Exhibit 6). Malls have discounted valuations for the current level of rates with little earnings risk. Utilities are relatively more expensive but is one of the rate sectors with upside earnings risk. Retail offers wide discounts which in our view already offset the risk of downwards earnings revisions. More volatile eCommerce/tech, education and toll roads show wide discounts that could not be enough to compensate earnings risk. **See sector details on page 4.**

Prefer selected financials, bond proxies, quality growth

We like exposure to lower rates through malls and selected utilities, quality tech and financials with bottom line directly related to the capital markets. We also have exposure to high beta names in transportation and health care. Traditional banks' valuations are not as sensitive to rates, but banks are trading 20% below hist avg (Exhibit 7).

The elephant in the room: commodities

If the entire Ibov ex-commodities rallies as much as 20%, that means Ibov at our target of 135k by year-end, assuming no price movements for commodity sectors. A stronger upside will likely be dependent on the performance of commodities. We have a positive view on oil names but have a more cautious view for iron ore and pulp for this year. Petrobras dividend yield alone could allow for another 600 points for the Ibov. If Vale's local share price were to increase 14% it would add 2k points to Ibov.

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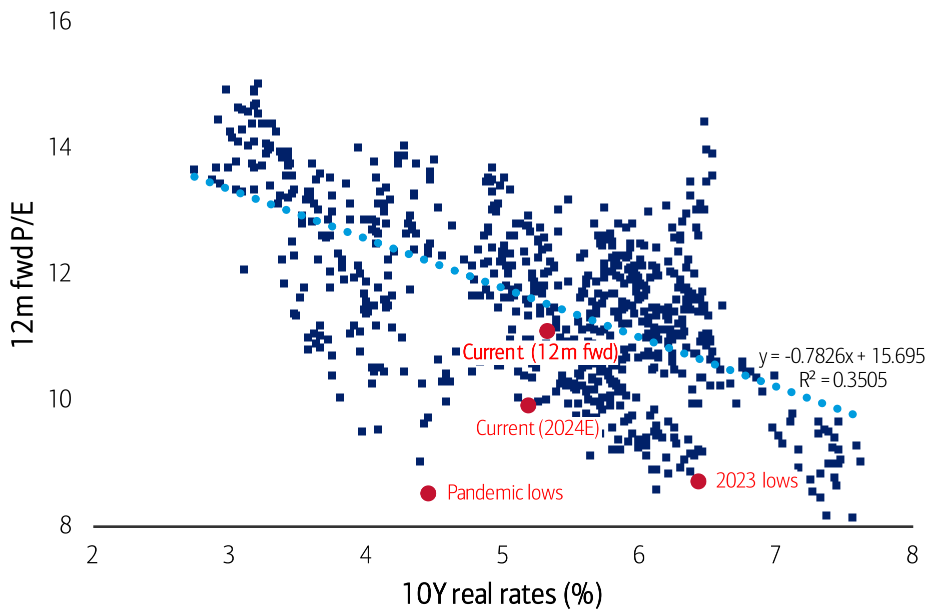
Current level of real rates allows for Ibov upside

Historical P/E for Ibov ex-commodities associated with 5.2% real rates (current level) is 7% higher than current 12m fwd P/E and 18% higher than current 2024E P/E.

Exhibit 1: Ibov ex-commodities 12m fwd P/E (Y-axis) vs Brazil 10y real rates (X-axis)
Valuation back to historical levels (given the level of rates) plus a 50bp decline in long term real rates can justify 21% upside and P/E 4% above hist avg (in term of 2024E P/E) for Ibov ex-commodities.



Source: BofA Global Research, Bloomberg Consensus estimates.

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Long-term market real rates could continue to fall

We forecast terminal selic at 9.5% in July 2024, which means 425bp selic cuts in total. So far, market real rates declined 124bp from the peak in March. That represents only 30bp decline for every 100bp selic cut we expect.

Historically, market long-term real rates fall more than that: 40bp for every 100bp selic cut (see summary in Exhibit 2). If real rates fall an additional 50bp from here (from 5.2% today down to 4.7%), the decline per 100bp selic cut would be in line with past easing cycles. But we think that part of the move this year was just risk premia decompression, and rates could decline more than that.

Exhibit 2: Size of past easing cycles in terms of selic cuts and market rate declines (bp)
In the last three easing cycles, market 10y real rates declined 40bp for every 100bp selic cut.

Date			Total decline (bp)			Decline per 100bp selic cut (bp)	
Market rates start to decline	First selic cut	Last selic cut	Selic	Market 10y nominal rates	Market 10Y real rates	Market 10y nominal rates	Market 10Y real rates
Aug-11	Aug-11	Oct-12	525	308	281	59	54
Mar-16	Oct-16	Mar-18	775	527	189	68	24
Oct-18	Jul-19	Aug-20	450	345	196	77	43
Mar-23	Aug-23*	Jul-24*	425*	304**	124**	72**	29**
Average of the last three cycles						68	40

Note: (*) BofA Forecast. (**) Up to current date. Market rates may continue to decline as the easing cycle moves forward.
Source: BofA Global Research, Bloomberg

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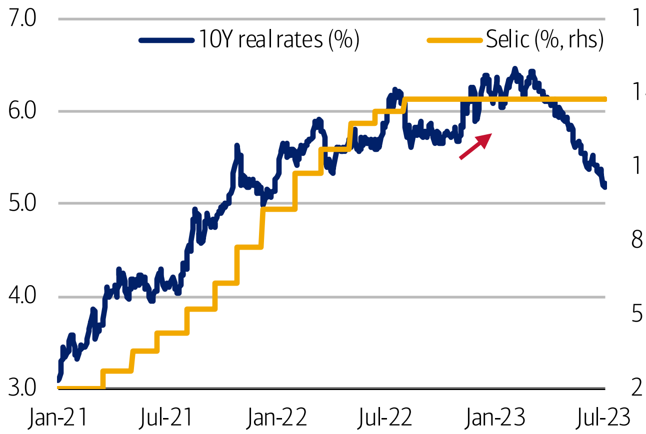
Risks are for a bigger decline in real rates

We think that real rates could decline more than 50bp. In our view, at least part of the decline in real rates we saw this year can be attributed to risk premia decompression and not exclusively to an anticipation of selic cuts.

The peak of real rates in 2023 happened during heightened political noise, which has significantly lessened since then. Discussions at the time revolved around the inflation target and the fiscal framework. Exhibit 3 shows the increase in real rates even after selic hikes ended. Exhibit 4 shows the level of Brazil CDS at the time.

Finally, there is also a risk that the market starts to price in even more cuts (i.e, terminal selic below 9.5%) as we move forward with the easing cycle.

Exhibit 3: Brazil market 10y rates vs selic (rhs)
We saw an increase in real rates even after selic hikes ended.



Source: BofA Global Research, Bloomberg

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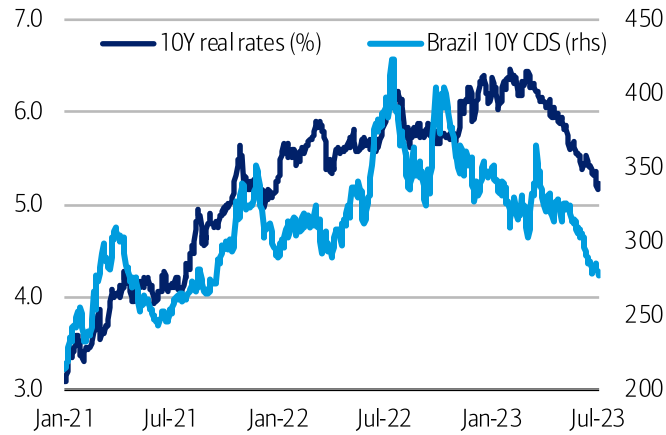
Exhibit 4: Brazil market 10y rates vs Brazil CDS (rhs)
A portion of the decline in real rates we saw this year can be attributed to risk premia decompression



Source: BofA Global Research, Bloomberg

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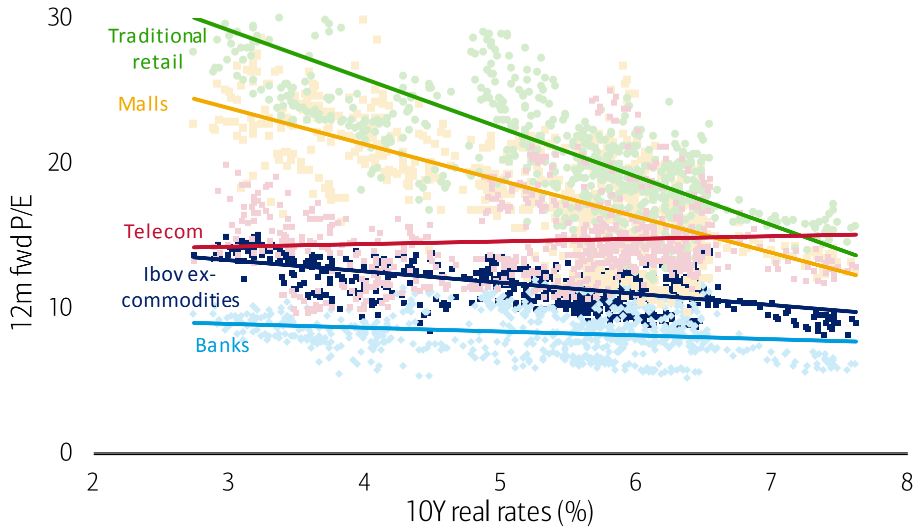
Sector views

We expect a re-rating process driven by lower long-term real rates to be steeper for growth names, high beta and bond proxies (Exhibit 5). Valuation for defensive sectors and banks have the least sensitivity to a change in market real rates.

Exhibit 5: Sector valuation (Y-axis) vs Brazil 10y real rates (X-axis)

Bond proxies (malls) and higher beta names (retail) are more strongly correlated to the change in market 10y real rates compared to low beta names (telecom) and banks (beta close to 1 and counter-cyclical earnings).



(*) P/FFO (12m fwd) for malls. P/E (12m forward) for the rest. Consensus estimates.
Group details - Malls: Multiplan, Iguatem. Toll roads: CCR, Ecorodovias. Traditional retail: Renner, Arezzo. Utilties: Eletrobras, Equatorial, Copel, Cemig, Engie, Taesa. Banks: Itau, Bradesco, Santander Brasil, Banco do Brasil. Telecom: Vivo (Telefonica Brasil), TIM.
Source: BofA Global Research, Bloomberg

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Banks: counter-cyclical trading at discount

Large banks: Counter-cyclical trading at discount.

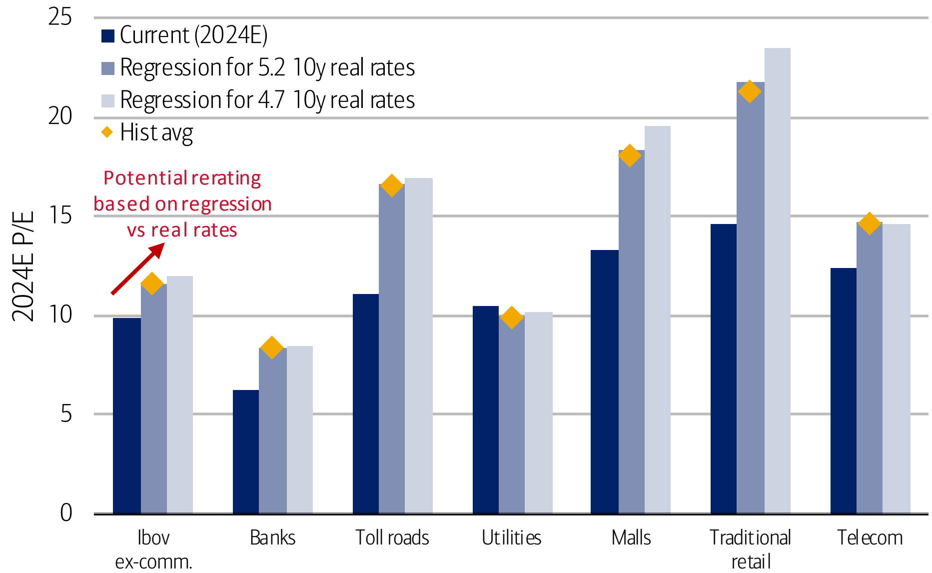
Banks' valuations in terms of P/E are not meaningfully sensitive to the level of rates (as evidenced in Exhibit 2), and neither are P/Book ratios (as shown in Exhibit 5). Yet, we see room for rerating as large banks are trading today at 1.1 P/Book (trailing), 20% below historical average of 1.4 P/Book.

Positive drivers for banks would be earnings momentum in 2024 given improving economic activity and normalization of the asset quality cycle.

Non-banks: Prefer top-line growth linked to rates

Payment processors' valuations are attractive, but we see tougher than expected competition and decelerating industry growth (see Electronic Payments – Brazil: Encouraged but not yet convinced). Insurers' operating trends are positive, but we see lower rates as potentially negative for financial results (see Insurance – Brazil:

Exhibit 6: Valuation levels according to the level of rates
Toll roads and traditional retail show the biggest rerating potential given the current level of rates, but they also have the biggest earning risk.



(*) P/FFO (12m fwd) for malls. P/E (12m forward) for the rest. Consensus estimates.
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Source: BofA Global Research, Bloomberg

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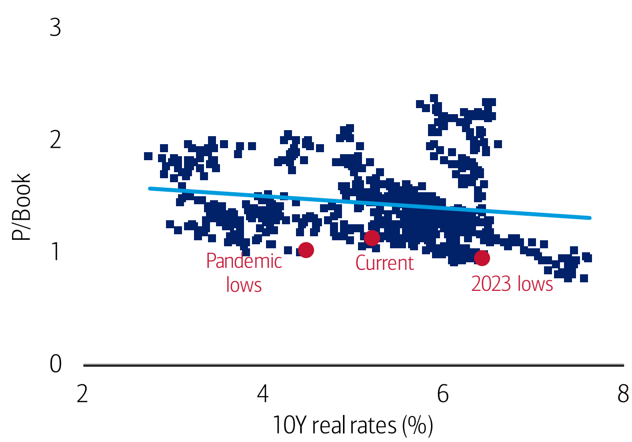
Exhibit 7:Banks P/Book (trailing, Y-axis) vs Brazil 10y real rates (X-axis)
Banks P/Book value are not meaningfully correlated to the level of rates.



Banks: Itau, Bradesco, Santander Brasil, Banco do Brasil.
Source: BofA Global Research, Bloomberg

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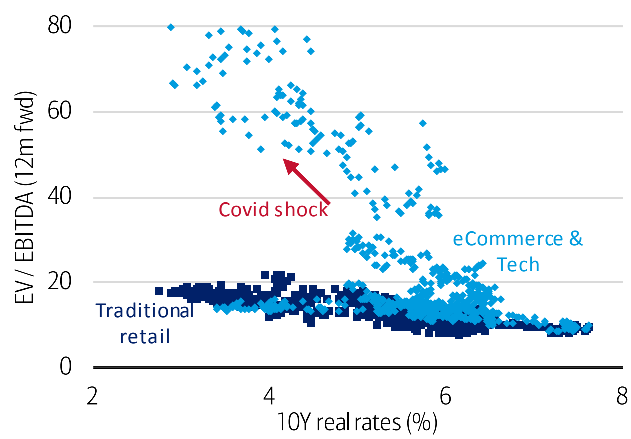
Exhibit 8: Sector 12m fwd EV/EBITDA (Y-axis) vs Brazil 10y real rates (X-axis)
The valuation gap between of traditional retail and eCommerce+Tech widened the most during the Covid shock.



Traditional retail: Renner, Arezzo. eCommerce + Tech: Magazine Luiza, Via, MercadoLibre, Totvs. Consensus estimates. **Source:** BofA Global Research, Bloomberg

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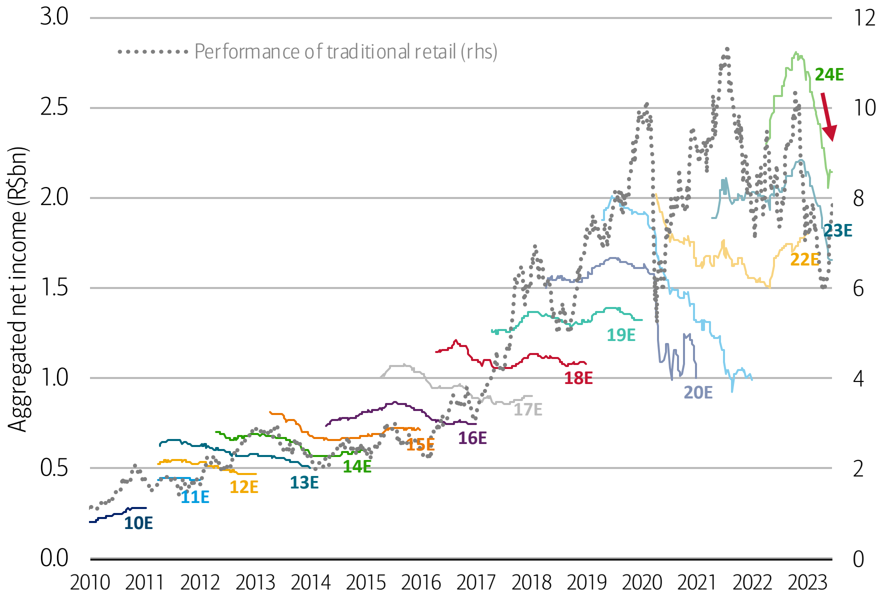
Retail & high beta: watch for EPS risk

Retail poses one of the biggest discounts vs historicals, even after adjusting for the level of rates (Exhibit 6). In fact, the current level of rates historically would have granted close to 50% higher valuations vs today (2024E). This is even more apparent for eCommerce and tech, due to the surge in valuations during the Covid shock (Exhibit 8).

We acknowledge that downwards earnings revisions are a key risk for 2024. Still, wide discounts would still allow for sizeable earnings revisions. Plus, consensus earnings revisions appear to have stabilized. (Exhibit 9)

Other high beta sectors with high earnings risk are homebuilders, leveraged healthcare and transportation, education, and small cap tech.

Exhibit 9: Traditional retail (Renner & Arezzo) aggregated consensus earnings estimates
2024 earnings estimates declined sharply in 2023



Consensus estimates. Traditional retail includes Renner and Arezzo. Performance calculated using equal weights. Total returns in BRL.
Source: BofA Global Research, Bloomberg.

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Bond proxies: Malls offer best mix of re-rating potential & little earnings risk

We discussed the main beneficiaries of the rate cuts ahead in Brazil Bond Proxies: Further and faster rate cuts: shifting preference to Malls.

Malls still trade at spreads from rates 130bps above historical, which could provide additional upside once the cycle begins. They offer one of the biggest reaction functions to lower rates, whilst offering little earnings risk. See Not late for the party: why we still like malls post-rates rally in 5 charts.

Utilities screen as relatively expensive compared to other bond proxies (current valuations closely resemble historicals for the current level of rates, Exhibit 6). Still, we stick to our more optimistic view that Utilities (namely power distributors) could still benefit from regulatory de-risking (albeit facing volatility, see Brazilian Utilities: DisCo renewal: negative surprises & pushbacks – a lot to be discussed). Upside risk for earnings revisions for the sector arise from turnaround stories, growth, and regulatory reviews.

We see transportation as the least attractive in terms of risk-return after recent outperformance.

Staples & essential services

Lower beta names are, by definition, less exposed to a rerating driven by lower rates. Industries such as telecom, supermarkets, food and agri could underperform in a continuation of the bull cycle, but we expect positive returns. Plus, industries have positive drivers that could help performance.

Positive drivers for protein processors are rising beef prices and lower cattle costs, mainly in Brazil.

Brazil supermarkets are leveraged and could benefit from lower rates, but unlikely to offset declining food inflation and operational headwinds.

The elephant in the room: commodities

Iron ore and pulp cycles are not supportive of higher valuations

We have a more cautious view on iron ore and see some downside for the commodity for end of the year. On the other hand, supply/demand dynamics could improve into 1Q24 on better seasonality (rain season hurting production in Brazil and Australia).

If Vale increases 14% that alone would translate into additional 2k points for Ibov. News around China stimulus would be the main trigger for iron ore prices bottoming sooner than expected, in our view.

We are also wary of pulp prices going forward, expecting prices to remain sideways over the next quarters as substantial new capacity hits the market.

See more details in Mining, Steel, Pulp & Paper – LatAm: 2Q23 Preview – one for the Bears.

Oil: Petrobras'dividend yield most relevant for Ibov

We have a house view for oil that is more constructive than the Street. We expect BofA's latest forecast for oil prices in 2023 US$80/bbl (compared to US$73/bbl market prices for the next 12 months).

Petrobras dividend yield alone (18% for 2024) represents 600additional Ibov points. We highlight, however, that a new dividend policy is expected to be announced this month. As announced in the 1Q23 result, Petrobras's Board of Directors instructed the executive board to prepare a proposal to "improve" the current Shareholders' Remuneration Policy, including the possibility of repurchasing shares, and submit it for deliberation by the Board before the end of July.

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