The Equity Investment Prospects for Brazil

Date: 22 August 2023

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1. Introduction

Equity prospects in Brazil are good. We will be evaluating the equity prospects in Brazil by analyzing the at the macroeconomic performance, the Foreign Exchange Rate (FOREX) stability as well as the Stock Market performance.

2. Macroeconomic Performance: Brazil

The landscape of Brazil’s macroeconomic prospects is neutral. The interplay of fiscal policies, structural reforms, external market conditions, and domestic resilience, will simultaneously shape the country's economic trajectory and its capacity to navigate obstacles and seize opportunities in the upcoming years.

The first economic indicator is unemployment. Since the covid pandemic where the unemployment rate reached a double-digit peak of 14.9% in the first quarter of 2021, it has fallen to 8.3% as of May 2023, underscoring a resilient moderation. The downward trend in the unemployment rate can be underpinning a strengthening labour market according to the Brazilian Institute of Geography and Statistics. This is expected to support higher household consumption.

Owing to the current hawkish policy environment, the second economic indicator we look at is a combination of the headline inflation rate and the interest rate, with the former currently at 3.99% as of July 2023 – see figure 1. Inflation within Brazil has proven to be less sticky over the medium term, with a return within the target band of 1.75% and 4.75%. The Banco Central do Brasil (BCB, the central bank) held its benchmark Selic interest rate (federal funds rate) at an elevated 13.75% at the previous meeting in May 2023 for the sixth consecutive meeting since August 2022.

The government fiscal deficit has been a significant determinant of the inflation rate. Hence, fiscal consolidation efforts from the government side will also play a role in creating a deflationary environment through the channel maintaining a narrow fiscal deficit by restricting the supply of cheap credit. Tax simplification reforms through adopting easier operational efficiency and lower compliance costs as well as strict fiscal policy is expected to be the theme going as these benefits may start accruing from early 2024. This Fiscal framework will improve the Monetary Policy (MP) stance the BCB predicts that easing in interest rate may begin from August 2023 and should reach 8.9% by early 2025. Interest rate differentials narrow as inflation continues to subside.

The last economic indicator is economic growth which came in at 2.9% for 2022 giving us an overall snapshot of where the economy stands. Investment and household consumption is likely to improve going forward with MP indicating that they have reached the peak of the rate hike cycle. Agricultural exports and other key commodity exports is also likely to improve with higher global demand.

2. Exchange Rate Stability: Brazil

The floating exchange rate stability is neutral because of their well standing international reserves quoted at USD354,623 million as at end of 2021, see figure 2. A fair proportion of the stability on exchange rate relies on the how wide the fiscal deficit is. Assurance by the Brazilian government has been communicated in that much of the fiscal spending programmes which aimed to boost the economy have been halted for the short term at least. Overlaying that the BCB kept interest rates constant for the sixth consecutive meeting, however, the Real (domestic currency) is likely to face currency pressures with respect to the US dollar. On the other hand, a boost in exports through the grain harvest will improve the trade balance albeit commodity prices falling from the Russia-Ukraine conflict peak. This is expected to narrow the current account deficit to 1.9% of GDP for 2023 from 3% of GDP in 2022. In addition, projections from the BCB show that the significant agricultural export demand boost (mostly with Mainland China) will maintain the nation's trade surplus until 2027. Nevertheless, the cushion of the total International Reserves on month of imports is 18.13 as at 2021 which is strong relative to other emerging markets.

Brazil uses a floating exchange rate system; this allows it to fluctuate in response to foreign exchange market events. Out study on the Brazilian Real was on analyzing the autoregressive moving average trend. It was then noted that predicting the Brazilian Real by estimating the lagged (past) effect of the Real, provides a fit to the model and slightly more precision in our forecast. The trend for the Real shows it be slightly depreciating over the short run, however, the fundamentals are not shifting significantly. The volatility in the currency is quite low with major shocks not trickling down into major movements in the exchange rate. In short, sustaining support of the Real from various fundamentals mentioned above, we forecast that there will be a slight appreciation over the medium term.

3. Stock Exchange Prospects: Brazil

Brazil's stock exchange market prospects are at a point of inflection owing to the nation's capacity for sustainable growth and appealing investment in fintech opportunities. The trend in the IBOVESPA index over the last five years (from 2018) has been moderately stable. There has been shocks in the market with the stock market embarking on a sharp downtrend in 2019 owing to the covid pandemic where economic activity was dormant. We then note a recovery, from the second quarter of 2020 amid the panic-selling and stock market crash, see figure 3. However, the stock market has not yet returned to its pre-pandemic level and continuing trend thereafter. High inflationary environment has resulted in continuous pricing in of interest rate hikes by the market, as a result, the recovery to those 2019 levels has been slowed down even though we do see slow improvement since economic activity has resumed at increased capacity. We also do get a flavour that in general, time in the market beats timing the market. Historically as shown in table 1, the average monthly return over 5 and 2 years is 0.95% and 0.45%, respectively. If one invested $10,000 say 5 years ago the return could have been as high as 17.61% this is excluding any dividend returns over the period - dividends reinvested would have provided an even higher return. This reinforces once more how strong compounding returns can work in one's favour.

It should be said that emerging markets have higher returns and expected returns in comparison to more established and developed nations. This is owing to a significantly higher return attached to emerging economies. The monthly risk factor in Brazil's stock market has subsided slightly from 10.39% to 9.30% and then at 7.43% in the last five, two and past year, respectively. This helps us understand how risk is also higher over the long term in Brazil than it is over the short term, owing to less uncertainty over the short term.

We now shift our focus to briefly unpacking whether there are market efficiencies in Brazil's stock market. The correlation between the IBOVESPA and the S&P 500 (USA), the Euronext 100 (Europe) and the N225 (Tokyo) has been moderate around 0.54, 0.56, and 0.5 respectively over the previous five years. This is indicative of there not being a strong correlation between the Brazilian stock market as well as the other stock markets. This provides investors with an added level of diversification as drivers in the one market will not entirely affect the Brazilian stock market. Despite how indeed there is higher risk in Brazil, the risk is not highly correlated with the more established markets, as shown in table 2. Running a simple regression to test for the market efficiencies we regressed the monthly returns of the IBOVESPA over a 20-year period against past (lags) stocks returns and found that none of the test-statistics were not significantly different to zero implying that current returns are not entirely affected by lagged returns. Perhaps caution at this point would be that there are other factors that influence market efficiency and can indeed be showed in more robust manner by including those other factors exogenously into the regression equation. Our conclusion is that markets in Brazil are indeed efficient, in other words, stocks reflect information that is publicly available based on the evidence from table 3.

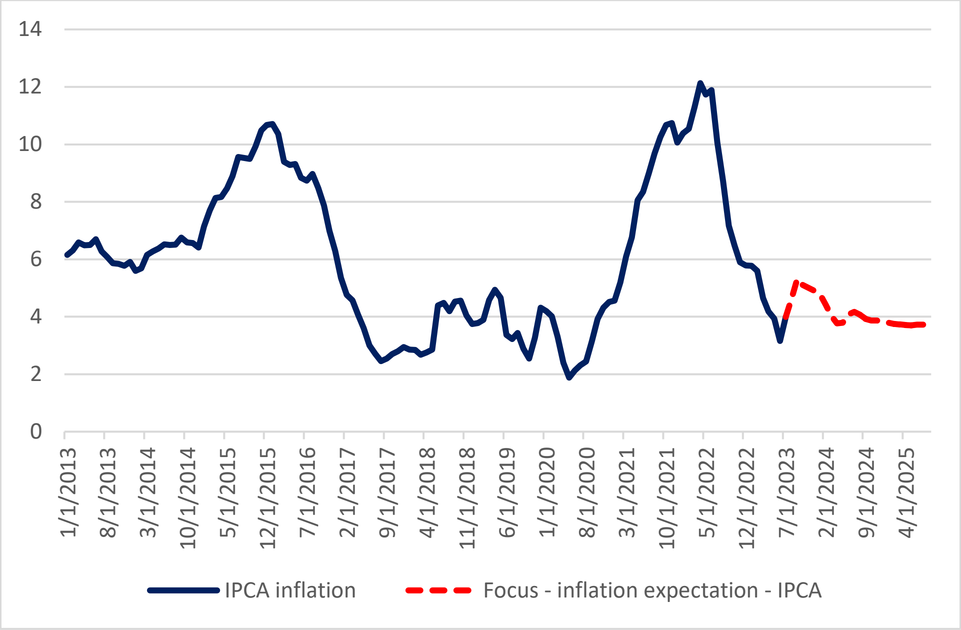
The overall financial services sector has recovered from the covid pandemic pull-back. According to the BCB, who ran a stress test, noted in the Financial Stability Report that the banking sector remained resilient even under adverse economic conditions. The pandemic has helped fast track the need for Financial Technology (Fintech) firms and has seen a quicker rise in startups as more entrepreneurs are looking for innovative ways of allowing clients to conduct business within having to leave their homes or visit a branch. Government is also investing in allowing for a smooth transition of citizens and access to digital channels.

Conclusion

In conclusion, we see that the macro performance is balanced. In addition, the FOREX stability hinges on well-standing International Reserves with up to 18 months of imports of cover. Lastly, the stock market displays lucrative opportunities with moderate correlation to established markets. Thus, our standing on Brazil on a rating scale is good.

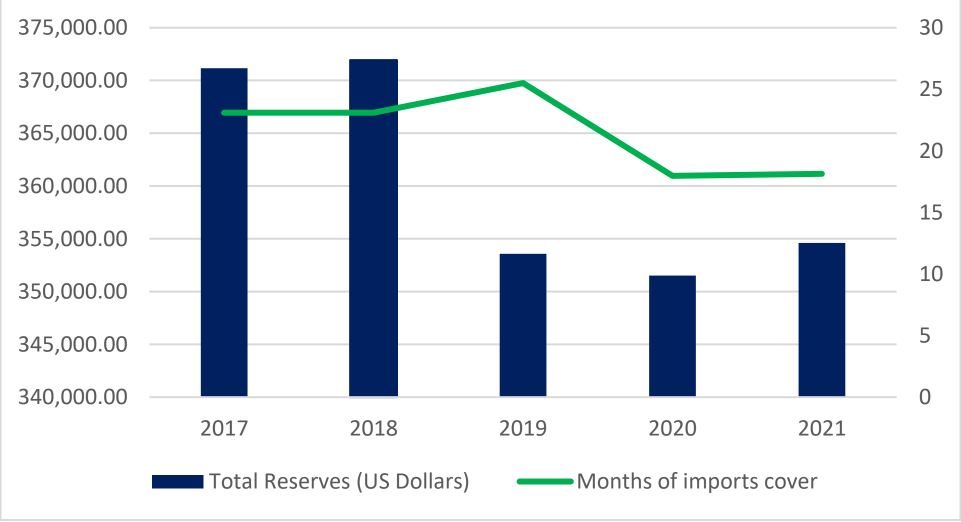
Appendix

Figure 1: Inflation rate and inflation expectation



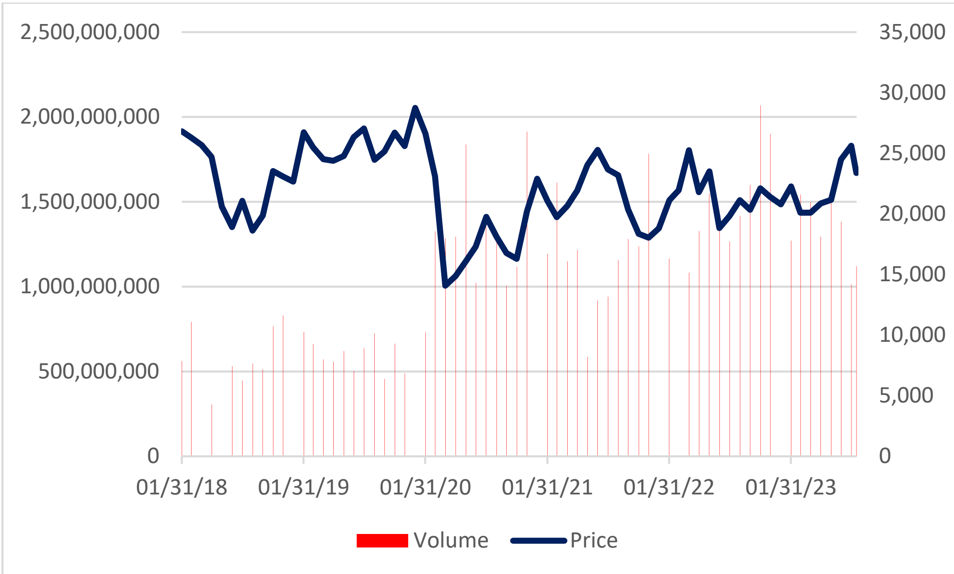
Source: BCB

Figure 2: International Reserves (months of imports cover)



Source: IMF

Figure 3: Brazil: IBOVESPA (^BVSP) stock index



Source: FX Sauder UBC

Table 1: Risk and Returns for Brazil Stock Market

	IBOVESPA	*Average Returns (monthly)*	*Risk (monthly)*
1 year	0.149	0.011	0.074
2 years	0.147	0.005	0.093
5 years	0.176	0.010	0.104
10 years	-0.006	0.006	0.101

Table 2: Correlation Matrix of Stock Market Returns

5 years	**S&P 500**	**Euronext 100**	**N225US$**	**IBOVESPA**
S&P 500	1.00			
Euronext 100	0.88	1.00		
N225US$	0.81	0.82	1.00	
IBOVESPA	0.54	0.56	0.50	1.00

1 year	**S&P 500**	**Euronext 100**	**N225US$**	**IBOVESPA**
S&P 500	1.00			
Euronext 100	0.84	1.00		
N225US$	0.86	0.77	1.00	
IBOVESPA	0.69	0.50	0.55	1.00

Table 3: Efficiency Test

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	0.009	0.007	1.309	0.192
R(t-1)	0.085	0.066	1.297	0.196
R(t-3)	0.007	0.066	0.105	0.917
R(t-6)	0.028	0.066	0.431	0.667

None of the t-stats are above 2