30 April 2025, 04:37PM UTC
Chief Investment Office GWM
Investment Research

A different risk-off wave

Investing in Brazil

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- As a consequence of the recent escalation in the trade dispute between the US and China, most currencies have appreciated against the USD, the probability of a US recession has risen, US consumer confidence dropped, and short-term inflation expectations have jumped.
- Market participants have been reacting differently compared to past high-stress situations, especially regarding the role of the USD and US Treasuries. This is a consequence of the market's questioning about how safe those assets will be in the new world.
- While we disagree with the view that investors no longer consider the USD and US Treasuries to have safe-haven characteristics, we believe that the current market sentiment may trigger some changes in emerging market countries, like Brazil, where inflation expectations have already fallen due to a stronger BRL and lower oil prices.
- In our tactical asset allocation for local portfolios, we keep floating rate bonds and inflation-indexed bonds as Attractive, move local equities to Neutral from Unattractive, keep nominal bonds at Unattractive, and keep global assets, hedge funds, real estate funds, and alternative assets as Neutral.

As a consequence of the recent escalation in the trade dispute between the US and China, confidence indicators across the world plunged and markets first sold off sharply, though they later recovered. Equity volatility surged to pandemic highs, tech stocks saw their largest one-day rise since 2001, US long-end yields jumped despite growth concerns, and the USD declined despite a sharp rise in volatility, unlike its historical trend. In short, this was a different risk-off wave, in our view.

Most currencies have appreciated against the USD despite the rise in trade tensions. The probability of a US recession has risen amid policy uncertainties, US consumer confidence dropped to its lowest since January 2021, and short-term inflation expectations have jumped, according to the University of Michigan indicator.

Given all of this, the global outlook continues to be very fluid. Indeed, this time market participants have been reacting differently compared to past high-stress situations, especially regarding the role of the USD and US Treasuries. This is a consequence of the market's questioning about how safe those assets will be in the new world. Can the dollar lose its central role in the global financial system? Although the United States now accounts for about 25

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percent of the global economy, more than 57 percent of international reserves are denominated in dollars, according to the International Monetary Fund (IMF). In addition, the role of the dollar goes far beyond these statistics: it is the reference currency for most investors in the world. In foreign trade, 54% of global exports are invoiced in dollars; in the financial sector, about 60% of international loans and deposits and 70% of bond issuances use the dollar. In the foreign exchange market, 88% of transactions involve the American currency.

While we disagree with the view that investors no longer consider the USD and US Treasuries to have safe-haven characteristics, we believe that the current market reaction may trigger some outlook changes in emerging markets countries, like Brazil.

The focus of global investors at the Spring Meetings of the IMF and the World Bank, which took place in Washington, was to find clues to offer more clarity on the potential size of the economic shocks stemming from US President Donald Trump's tariff policy. But the finding, of course, is that uncertainties still reign.

For Brazil specifically, inflation expectations have already fallen due to stronger BRL and lower oil prices. Brazil's current interest rate level is very restrictive, but it remains unclear if it is restrictive enough, and policymakers do not yet have a clear picture on future decisions, according to central bank director Paulo Picchetti. In his presentation, he showed that the distribution of market economists' projections, captured in the Focus Bulletin, highlights how there is a lot of uncertainty around the estimates for inflation ahead, as well as for economic growth expectations.

In Brazil, core inflation, which excludes volatile energy and food prices, remains relatively elevated, indicating persistent underlying pressures. Given global uncertainty, the Central Bank of Brazil's prescription is to go slow and be transparent, according to the institution's Economic Policy Director, Diogo Guillen.

As inflation remains persistently above target, the risk of de-anchoring should increase. Therefore, it is necessary to be cautious with expectations at the end of a monetary tightening cycle—especially when current inflation still has resilient components, signs of a slowdown in activity are incipient, and the fiscal anchor remains fragile.

The BC could opt to short cut its tightening cycle, and even start cutting earlier than expected, especially if the USDBRL stays close to current levels in the coming months.

Fiscal challenges

The project that the government sent to Congress for the 2026 Budget Guidelines Law (LDO) explicitly spelled out the difficulties of the fiscal framework. According to experts in public accounts, the rules that were approved already in the current Luiz Inácio Lula da Silva government will become unsustainable if nothing is done in the coming years.

Even if it opts for a reform—which can be complex from a political point of view at this point—it will likely be difficult to save the framework in the face of the strong pace of growth in mandatory spending, in our view.

This pace is driven, for example, by the policy of real increases (above inflation) in the minimum wage. The theme was a campaign promise of President Lula and is one of the pillars of his government.

We see increasing fiscal pressure in the coming quarters, especially in a situation where the government's popularity is low and could face a hard time to recover. This situation can pressure local assets, even in a situation where the BCB is cutting rates.

Investment implications: Local asset allocation

Nominal bonds recently benefited from the drop in breakeven inflation in the markets, which came as a consequence of the rally in the BRL. The commodity price drop also contributed to the fall in inflation expectations, as the global markets adjusted to the risk of lower activity across the globe. Markets are currently expecting the policy rate to be cut by the second half of the year, six months earlier than what was expected one month ago. We keep nominal bonds as Unattractive.

We still favor floating-rate bonds, which presently offer attractive real returns of approximately 8.5% above the expected 12-month inflation print. This substantial yield cushion provides valuable defensiveness against potential inflationary surprises in the coming months.

Inflation-linked bonds are our favorite asset class currently, offering real yields of around 7.6%. These bonds are trading at real interest rates above historical averages and provide a useful hedge should inflation continue to accelerate or if the BCB unexpectedly pauses its tightening cycle. At current valuations, the carry offered by inflation-linked bonds is comparable to that of floating-rate instruments, assuming yields remain relatively stable in the near term. As a consequence, the carry is high enough to show competitive returns when compared to floating-rate bonds, and they still offer a hedge for inflation.

Local equities are facing headwinds amid slowing economic activity, persistent inflationary pressures, and sustained high interest rates. In the short term, we believe domestic investor flows into equities will likely remain negative. However, we see increased attraction by foreign investors in emerging markets equities and currencies, as a consequence of the tariffs tensions impacting negatively the USD. Based on our base-case scenario of no recession in the US, extreme low valuations in terms of historical price earnings ratio and foreign investors' interest on emerging markets, we move local equities to Neutral from Unattractive.

Global assets

Over the balance of 2025, we also see scope for a tactical recovery in US risk assets. We believe that tariffs are likely to have a relatively larger impact on the US economy than on most other large global economies. In our base case, we now expect US economic growth of 1.5% in 2025 versus the expectation of more than 2% growth we held earlier this year. We expect growth of 0.7% for the Eurozone in 2025 (around 0.2 percentage point weaker than when we entered the year) and below 4% for China (roughly 0.5 percentage point weaker).

If maintained, tariffs are also likely to adversely affect the US's long-term growth potential. The imposition of tariffs not only disrupts current trade flows, but is also likely to discourage investment and erode productivity in the US tradable goods sector.

Our base case is that the Fed will cut interest rates by 75-100 basis points this year. But in the near term, the Fed's policy flexibility appears to be more limited as it has to balance growth concerns against the risk of a resurgence in inflation.

We also do not expect additional US fiscal stimulus this year. The US has run fiscal deficits of 5.3-6.3% of GDP for the past three years. With the US debt-to-GDP ratio at 123% as of December 2024, and amid growing concerns about the US fiscal trajectory both in Washington and on Wall Street, we do not expect the fiscal deficit to rise significantly. In our base case, we do see tax cuts introduced in 2017 being extended, but doing this would only represent the absence of fiscal tightening, rather than fresh stimulus.

In recent years, a key driver of US equity market exceptionalism has been the performance of the US technology sector. Since the launch of ChatGPT in November 2022, the Magnificent 7 stocks have accounted for close to 60% of the S&P 500's gains.

Looking forward, we believe that the trend of innovation as a driver of long-term US—and, by extension, global—equity market performance will continue, despite potential near-term economic challenges and tariff headwinds.

In the long run, we continue to expect US companies to remain among the leaders in driving global corporate profit growth as they supply innovative products to the global economy. But we acknowledge that results for the next quarters may remain volatile as businesses adapt to the new environment with tariffs and elevated uncertainty.

USD quality fixed income will also remain an important part of portfolio diversification for investors, providing liquidity, income, and portfolio stability, in our view.

Gold has been the standout performer of 2025 so far. Purchases of exchange-traded funds (ETFs) have increased recently alongside ongoing central bank demand, supporting the precious metal. While our forecast stands at USD 3,500/oz at present, if US political uncertainty extends further, leading to greater demand for perceived "safe havens," we believe gold could rise toward our upside risk case (i.e., adverse macro scenario) of USD 3,800/oz.

We keep global assets, hedge funds, and real estate funds as Neutral in our tactical asset allocation.

Summing up, in our tactical asset allocation for local portfolios we keep floating rate bonds and inflation-indexed bonds as Attractive, move local equities to Neutral from Unattractive, keep nominal bonds at Unattractive, and keep global assets, hedge funds, real estate funds, and alternative assets as Neutral.

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Appendix

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Version D/2024. CIO82652744

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