Aegon Asset Management

POLICY OVER POLITICS: THE CURRENT CASE OF BRAZIL

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Politics plays an oversized role in investors' perceptions of emerging markets (EM). Politics can matter, but only inasmuch as it affects a country's policy path. Whether that political impact occurs directly on the real economy, or because political scandals erode the legitimacy of major institutions, what truly matters is policy.

EM investors can't consistently predict when a political scandal will erupt, but they can be prepared to know which political events matter for policy, and which ones don't. With a presidential corruption scandal roiling Brazil's markets, our approach seeks to understand how the events impact policy, if at all. In turn, we review our investment thesis to determine what opportunities are present in any security price dislocations.

Brazil has been in a protracted state of political scandal stemming from the so-called *Operation Car Wash (Lava Jato)* investigation, which began in 2014. Originally a money laundering inquiry, it has grown in scope and significance over time. However, the political ramifications from this operation have not yet been substantive enough to alter the country's underlying economic trajectory. That may be changing.

Recently, the Brazilian government, led by President Michel Temer and his center-right Brazilian Democratic Movement party (PMDB, using the Portuguese abbreviation), has been pursuing a set of market-friendly, growth-oriented structural reforms (e.g., labor market and pension reform). Neither set of reforms are publicly popular as they involve curtailing benefits. But, both sets of reforms are critical for long term debt sustainability and for revitalizing Brazil's economic growth engine. Here, success depends on the government's stability and credibility.

On May 17, a tape recording of President Temer was released to a local newspaper, ***O Globo.*** The tape was alleged to have President Temer actively involved in a bribery operation. While the bribery allegations are high political drama and affect real lives in Brazil, the scandal is not immediately critical to the long term credit and growth profile of the country. But the damage caused to the reform agenda, however, is critical. This may be a political scandal with implications for policy.

On May 16, we inferred from market prices an 80% probability of reform passing. Post-allegations, we think that market-implied probability has fallen to about 30%. What does this potential change in the policy path reveal for investors?

To help answer, we use a scenario analysis approach to estimate the fair value spread for 10yr Brazil government bonds. Applying our knowledge of the country's politics and credit, we generate a view of how successful reforms could lead to positive economic outcomes, while failed reforms might negatively impact macroeconomic and financial market variables at a point-in-time five years from now. Specifically, we estimate the possible changes to the country's public debt load, trend GDP growth, and trend inflation. Additionally, we forecast levels for the exchange rate (USDBRL), credit rating, key monetary policy rate (SELIC), and most crucially, the 10yr government bond credit spread.

Our view prior to the Temer tapes was that the market had too optimistically priced the high likelihood of pro-growth reform. Now that a political issue may derail those policies, market prices are more in-line with our initial view.

	Current	Negative Outcome	Positive Outcome
10yr Bond Fair Value Spread (bps)	Fair Value: **270** Spot: 280	**375**	**210**
Inflation (y-o-y %)	4.5	**6**	**3.5**
Public Debt (share GDP)	80	**92**	**70**
Rating (S&P)	BB	**B+**	**BBB**

Sources: AUIM, Bloomberg As of May 18, 2017
Notes: bolded data are internally generated estimates

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