Amid fresh market volatility in Brazil, in the face of a new political scandal, the long-term zero weighting in the Dreyfus Global Emerging Markets Fund has stood it in good stead. The Brazil market fell by just over 16% on May 18, triggering the market’s volatility circuit breaker. The fresh market volatility came as allegations that new Brazilian President Michel Temer condoned bribes to silence a key witness reportedly deflated investor optimism about the prospects for his pension and labor reform agenda.

Rob Marshall-Lee, manager of the Dreyfus Global Emerging Markets Fund at Newton Investment Management, a BNY Mellon company, has long been underweight in the country, even ahead of the latest scandal. As to the latest market volatility, he notes: “The sharp market correction in response to the Temer allegations is unsurprising. Equity, bond and currency markets had rallied through 2016 on a combination of improved politics, which gave more confidence that the government would sort out a number of issues challenging the economy. Improved commodity markets also had a positive impact. Unfortunately, both are now in reversal as China has withdrawn credit stimulus, which has taken its toll on commodities and this upset followed soon after. This presents a big challenge to the bull case, which in our view always looked optimistic.”

LONG-TERM VIEW ON BRAZIL

Brazil was a major beneficiary in the 2000s from a dramatic boost to its terms of trade from a commodity bull market. This was driven by Chinese industrialization that coincided with the aftermath of a commodity bear market lasting over a decade, which had seen supply retrenchment. Brazilian inflation also fell at this time, allowing a decline in interest rates that overlapped with the terms-of-trade boost, strengthening the Brazilian real and hence consumer purchasing power. This confluence of factors, together with favorable demographics and pent-up demand, sparked a powerful credit cycle and consumer boom that drove up company profits from a low base, leading to excellent stock market returns in U.S.-dollar terms over a number of years—a boon for investors in the country.

However, as Chinese commodity demand slowed and energy and metal supplies increased in response to higher prices, rising imports also grew due to greater consumption. This meant the terms of trade in Brazil deteriorated. Debt service costs as a proportion of incomes also rose as a result of greater borrowing over a number of years and the circular effect of substantial asset-price appreciation. Instead of allowing a correction in the terms of trade, the Brazilian government tried to sustain the high growth levels with fiscal expansion and through pumping credit into the economy via state-controlled banks, even as the private banks stepped back from the market.

THE CONSEQUENCES

We see the recent multi-year recession as the result of these policies becoming unsustainable in the face of the underlying deterioration in economic fundamentals. Markets are consequently forcing the Brazilian currency and cost of capital to adjust to a more realistic level. While the recession and the consequences of a number of corporate governance scandals have led to some positive political change, the underlying issues have not yet been fully addressed. The consumer recession has led to balance-sheet repair as consumers and companies pay down their debt, leading to weaker demand. This has resulted in lower corporate investment and job layoffs, visible in the surge of unemployment. This continues, but the rate of increase in unemployment has eased, which the market rightly, we believe, sees as positive. The political change and a commodity rebound in 2016 saw the market reduce its perception of Brazilian risk, leading to a currency rally, bond yield contraction and a stock market rally. This is particularly true in the case of resources companies with high operational and financial leverage, such as Vale and Petrobras.

REALITY CHECK

Unfortunately, this does not mean that we are “off to the races” and the stage is set for a multi-year bull market. The correction is not complete, not least owing to a 9% budget deficit that requires significant and unpopular political movement on inflexible costs such as overly generous pensions, which will require legislative change. The debt burden probably still needs to fall further, and this is not made easier by weak employment (and therefore wages—though this tends to be a lagging indicator) and the lack of fiscal room for maneuver. Therefore, while we believe the consumer environment may recover a little, the outlook is not rosy.

Chinese growth is likely to be far less commodity-intensive in the future and Brazil lacks competitive export industries outside resources due to a number of factors: prolonged high-tariff protection for domestic industries, which has left them uncompetitive; a currency that has been strong for many years; relatively unproductive workers; and expensive capital.

This does not mean that we see no potentially interesting investments in the country, just that we don’t expect the broad market rally of 2016 to be sustained. In our view, equities do not, in general, look like a good value under a cool-headed appraisal unless growth is much higher than we expect. The currency is not cheap and bond yields are far less enticing than 18 months ago, having fallen from 16% to 10%. We believe we can find more attractive opportunities elsewhere among emerging markets with more growth potential and lower risk.