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OCTOBER 2018

BRAZIL UPDATE

LATIN AMERICA FUND

Brazil suffered a severe recession in 2016, experienced anaemic growth in 2017 and will likely continue this trend through 2018. Therefore the fledgling recovery is yet to visibly reduce unemployment and kick-start cyclical growth. Indeed, the market is pricing in a continuation, and even deterioration, of this difficult environment.

We are, however, constructive on the country, currently 58% of our Latin America portfolio, as we find it extremely attractive from a technical, business cycle and valuation perspective.

ELECTION CATALYST

We believe the upcoming elections are likely to bring about a serious change in fiscal policy, resulting in a boost to corporate confidence. A poll by Datafolha released on 2nd October put Jair Bolsonaro, an ultra-conservative candidate, in the lead with 32% of the vote followed by Fernando Haddad, the PT/labour party candidate and successor to former President Lula da Silva, in second place with 21%. Moreover, whilst Bolsonaro's rejection rate was stable at 44%, Haddad's increased from 27% to 38%. This implies a strong probability of success for Bolsonaro in the second round run-off on the 28th October. Indeed, surveys indicate that safety and corruption are the two most important issues for voters; hence it is unlikely that Haddad can grow in stature as the broad population blames his party for Brazil's corruption scandal and economic malaise. In this way, we believe a Bolsonaro victory is likely, which would herald policy change for the country.

BUSINESS CYCLE
A PAUSE NOT A REVERSAL

Despite the headlines and a brief hiccup after the Truckers' strike earlier this year, an economic recovery is continuing. Recent evidence includes automotive sales, up 8% on a YoY basis as reported by Brazil's association of car dealers. Moreover, given loose labour market conditions, with unemployment at 12% and a negative output gap holding inflation around 4%, the central bank is likely to maintain its accommodative monetary policy, with short-term interest rates at a record low of 6.5%.

VALUATION
ADDS WEIGHT TO FUNDAMENTALS

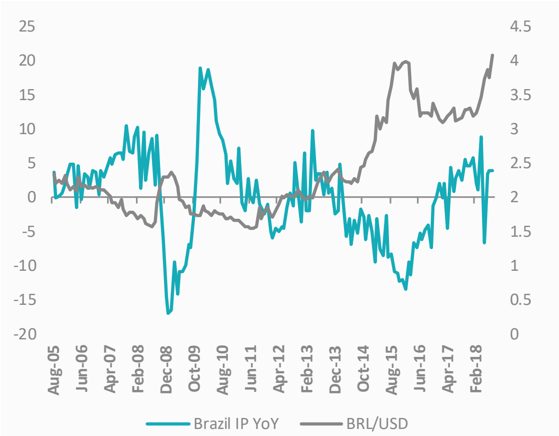
Brazil is also attractive from a market valuation perspective. Brazilian country risk, captured by the CDS spread (indicative of probability of default) has been increasing since Q1 2018. The widening spread is linked to a combination of the halt in fiscal reforms, negative economic impact of the truckers' strike in May and rising uncertainty regarding the presidential election. Indeed, we believe the current CDS price already discounts an unfavourable election outcome and no subsequent structural reforms. The depth of political will across all candidates is underestimated and thus there will be broad political support to normalise fiscal accounts, resulting in a decline in Brazil's CDS spread, which in turn will positively impact the value of equities.

Figure 1: Brazil's CDS

Source: Bloomberg

Indeed, we believe the best expression of a change in sentiment towards Brazil, is in Brazilian equities. This is not only because of their significant underperformance, but also due to considerable outflows from international investors. EPFR Global data indicates that the USD 6 billion of inflows into Brazilian equities during the 12 months up to April 2018 has not only reversed, but has seen a further USD 4bn outflow over the past 5 months. The top ten of our Latin America fund is dominated by Brazilian companies such as: CCR, an infrastructure operator, Banco Itau, the largest private sector bank, Ultrapar, best in class energy distribution industrial, B3 Bolsa, the largest integrated exchange in Latin America, and WEG, a world class industrial.

Figure 2: Brazil's industrial production and BRL/USD

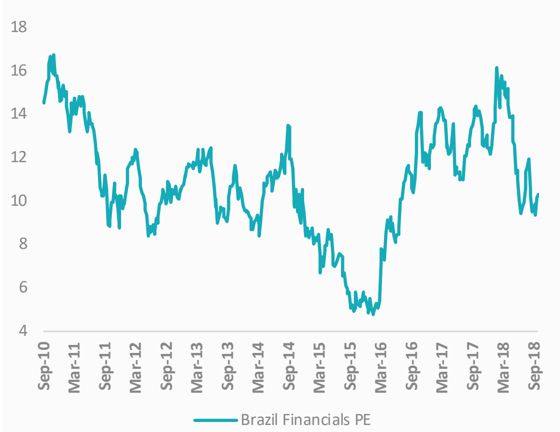


Source: Bloomberg

SEARCHING FOR VALUE IN THE EQUITY MARKET

We see considerable value across Brazilian equities, with a bias towards those companies with a strong domestic exposure. Two sectors of importance to our fund are Brazilian financials and Brazilian IT. We hold Banco Itau, the largest private bank, B3 Bolsa, the largest integrated exchange in Latin America, and Linx, the largest POS/IT systems operator in Brazil. Together they account for 17% of our fund, and are trading at 20% to 50% discount to our conservative valuations. Indeed, the financials sector is trading at recession lows of 10x trailing PE. A pro-business policy agenda will improve the growth outlook and should see them rerate towards a 14x multiple typically seen in a growth cycle

Figure 3: MSCI Brazil Financials PE



Source: Bloomberg

The Brazilian IT sector reflects all time low valuations, with the market pricing a combination of no growth and falling profitability.

Figure 4: MSCI Brazil IT PE

Source: Bloomberg

CONCLUSION

The market is deeply sceptical and has heavily discounted asset prices on the basis of dysfunctional politics. We believe this view ignores the realities; the political class are under no illusions that fiscal reform is required, despite the roadblocks Brazil's recovery has been delayed rather than reversed and valuations already discount a significant deterioration. In short, we see similarities to 2002, 2009 and 2016, years in which a massive change in Brazilian politics coincided with a violent drop in risk premia and sharp equity market rallies. Our positioning reflects our optimism and is biased towards out of favour, high quality companies that in some cases offer over 100% potential returns.

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Sources: Alquity, Bloomberg

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