

MARKET INSIGHTS ALERT

A Short Note on Brazil's House of Cards

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(A conversation between St. Peter and God on the seventh day of God's creation of the earth)

St. Peter: *My Lord, I marvel at all that you have created, but there is one land, to which I believe you have bestowed too much. [Pointing down at Brazil] You have created a land of temperate climate, fertile soil, endless fruits, unsurpassed beauty, abundant water, bountiful resources of all varieties, and yet free from hurricanes, volcanoes, earthquakes, tornadoes, tsunamis or other natural disasters. Why my Lord do you show so much favor to this one land?*

The Lord: *Ahhh, but you have not seen the people I shall give it!*

Brazilians are famous (or at least stereotyped) for their supposedly laid back "tropical" attitude towards life. Generations of foreign visitors smitten by the profound beauty and docility of Brazil's natural landscape have marveled at "the Brazilian way" (o jeitoinho brasileiro) of managing what to outsiders appears to be a relaxed, happy-go-lucky life amid structural chaos, bureaucratic ineptitude, and economic disarray. The old and famous Brazilian joke cited above pokes fun at these seeming contradictions.

Today, Brazil is once again seemingly reminded of God's evenhandedness.

The political crisis in Brazil has now exceeded any level of credibility for a realistic script in one of Brazil's famous novelas (serial soap operas). In case you haven't been watching this unfolding drama, here are some of the recent highlights (lowlights?). On Friday, March 4, former Brazilian President Luiz Inacio da Silva ("Lula") was briefly detained for questioning by federal police in an obvious (and potentially desperate) political move by Sérgio Moro ("Moro") the investigating prosecutor of the Lava Jato (Carwash) scandal enveloping the political classes of Brazil. In response to the political escalation, on Wednesday, March 16, Brazilian President Dilma Rousseff ("Dilma") appointed Lula as her Chief of Staff (previously Dilma's role under Lula) in a blatant move to place Lula outside of Moro's jurisdiction for the Lava Jato investigations (Ministerial level appointments are subject only to the jurisdiction of Brazil's Supreme Court). In response, Moro released a series of audio tapes obtained from wiretaps on Lula's phone which, inter alia, confirmed the deliberate intent behind Dilma's political machinations, while adding a rich trove of distinctly dodgy (not to mention explicit) conversations to the public record. On Thursday, March 17, amid protests both inside and outside the presidential palace in Brasília, Lula was sworn in as Dilma's Chief of Staff. Minutes later, a federal judge in Brasília issued an injunction against the appointment. Then on Friday, March 18 a separate federal judge annulled the injunction, putting Lula back on track to be sworn in (again). The case would now need to be resolved by a federal appeals court in what is being called by many foreign media outlets a "constitutional crisis". Meanwhile, the largest street protests in at least 30 years continue in cities all across the vast country, generally calling for Dilma's removal while the Brazilian Congress, which in the best of times makes the U.S. Congress look like a paragon of order and harmony, is plodding along with impeachment proceedings against Dilma (see the estimated timeline below, [TABLE 1](#)).

TABLE 1 Impeachment Timeline

As of March 16, 2016

House	Senate
<ul style="list-style-type: none"> March 17-31: Special House Committee on impeachment to be set up. Said committee will have 65 members, and pro-Rousseff forces at the moment seem to have a slight majority (some 36 members), although the situation is fluid. April: Special Committee report presented to the committee. May 1-7: Committee votes on the (non-binding) report. May 8-15: House floor votes on impeachment. The proposal is approved if 342 representatives vote for it. 	<ul style="list-style-type: none"> June 1-15: Special Senate committee votes on whether to impeach the president. Then the Senate floor votes on this issue. The proposal is approved if a simple majority (41) senators vote for it. The president would immediately step down and be replaced by the VP. June 16-July 15: The president presents her defense. July 15-31: Special committee issues report on whether to ultimately remove the president or not (assuming no congressional winter break). August 1-15: Senate floor tries the president.

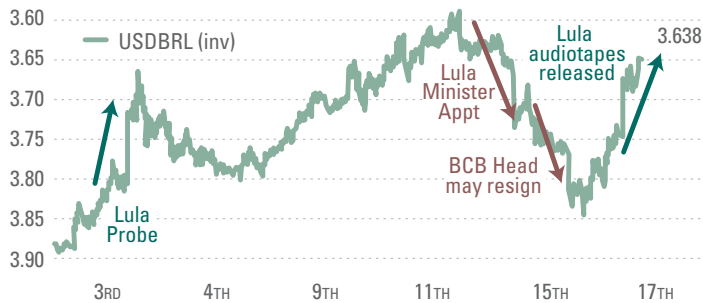
¹An alternate slightly more politically charged punchline goes: "Ahhh, but you have not seen who I shall put in charge of it."

Strangely, perhaps in a sign of how bad things in Brazil had gotten, markets are seemingly buoyed by all this political absurdity. The inferred assumption of the market behavior is that all of this political chaos, must be hastening the demise of the Dilma/Lula/Workers' Party regime which has led Brazil into its present recession (see CHART 1). In this thinking, all news that is bad for Dilma, is good for Brazilian assets. But it seems that the markets have a short memory. The political crisis in Brazil is largely the outgrowth of the economic downturn, and not vice versa (the Lava Jato investigation only really gained traction when Petrobras' largesse dried up with the collapse in oil prices and the impeachment charges stem from Dilma's attempts to use accounting tricks to hide the true size of the budget deficit). Thus, we find the market's reaction to Dilma's political plight to be little more than "irrational exuberance." The Brazilian economy is still contracting, the property market is overextended, the fiscal drag is deepening, inflation is at least staying high if not threatening to accelerate, and earnings

continue to be stretched (see CHARTS 2 THRU 5). Even if Dilma were ousted tomorrow, there is no outcome in at least the coming 12-24 months that would yield a political consensus that could reverse Brazil's worsening fiscal trajectory. Even a substantial rebound in commodity prices would only offer a temporary reprieve for this stage of Brazil's economic cycle, and such a reprieve might then only serve to buffet the Dilma government and thus again hurt market sentiment.

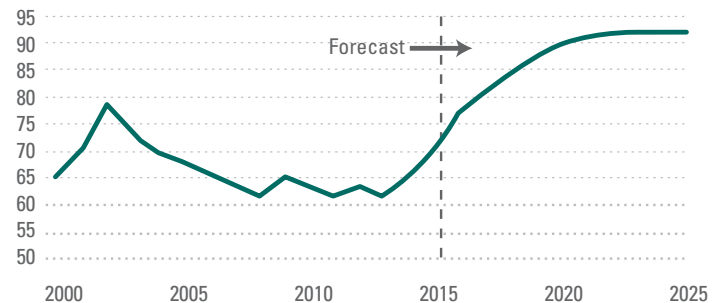
We are not chasing this wishful rally in Brazil. While we hope that the present crisis could ultimately yield an important turning point in Brazil's political culture, we see any such change as manifesting itself tangibly very slowly. However, in such times of market turbulence, strong bottom-up stock-pickers who can peel back the layers of disarray in the Brazilian market may be afforded uniquely attractive entry points for long term returns.

CHART 1 Brazilian Currency Movements (March 2016)



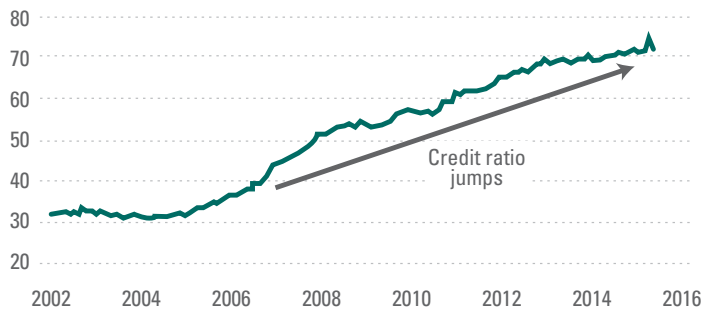
Source: Factset

CHART 2 Public Sector Debt (% of GDP)



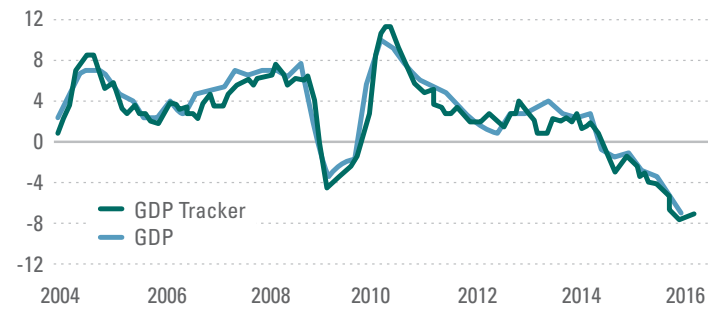
Source: Capital Economics (Forecast based on Capital Economics estimates)

CHART 3 Private Sector Debt (% of GDP)



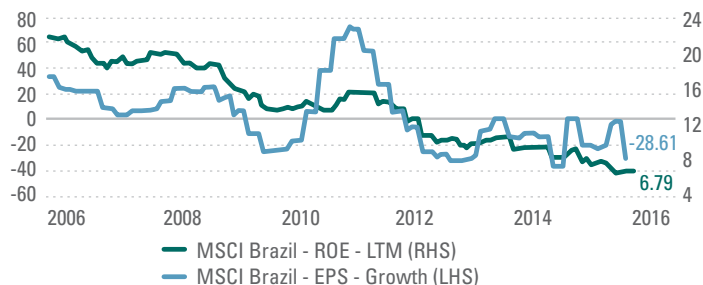
Source: Capital Economics

CHART 4 GDP Tracker & GDP (% , Year-Over-Year)



Source: Capital Economics (GDP Tracker based on Capital Economics data)

CHART 5 Declining Earnings and Returns in Brazilian



Source: Factset

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