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# Brazil Equity Strategy – Playing Low Rates, GDP Acceleration, and Macro Adjustment

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*October 2019*

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# Post-Pension Reform Agenda

# What is the growth agenda?

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## Improvement in business conditions:

- ✓ Tax reform
- ✓ Bill changing regulatory framework for the sanitation sector
- ✓ Bill changing the telecom sector's regulatory framework (PLC 79/16) - **APPROVED**
- ✓ Bill to change the gas industry
- ✓ Bill making it easier to do business in Brazil (MP 881/19) - **APPROVED**
- ✓ Import tariff cuts

## Privatizations, concessions, and asset sales:

- ✓ BNDESPar to sell its equity portfolio (~R\$120bn)
- ✓ Concessions of oil fields and transportation services (e.g. airports, toll roads, railroads)
- ✓ IPO of some financial services (e.g. Caixa insurance, credit card business, lottery)
- ✓ Bill to privatize Eletrobras
- ✓ Bill to allow foreigners to buy more land in Brazil

## Reduction in cost of capital:

- ✓ Monetary easing
- ✓ Bill on Central Bank autonomy

# Brazilian tax reform - Summary

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## Goods & Services

- ✓ Federal VAT (Cofins, PIS, IPI)
- or
- ✓ Dual VAT\* = Federal VAT + (ICMS, ISS)

## Income & Profits

- ✓ Reduce Corporate Tax (IRPJ & CSLL)
- ✓ Reduce Personal Income Tax (IRPF)
- ✓ Remove/Limit Tax Deductions
- ✓ Tax Dividends

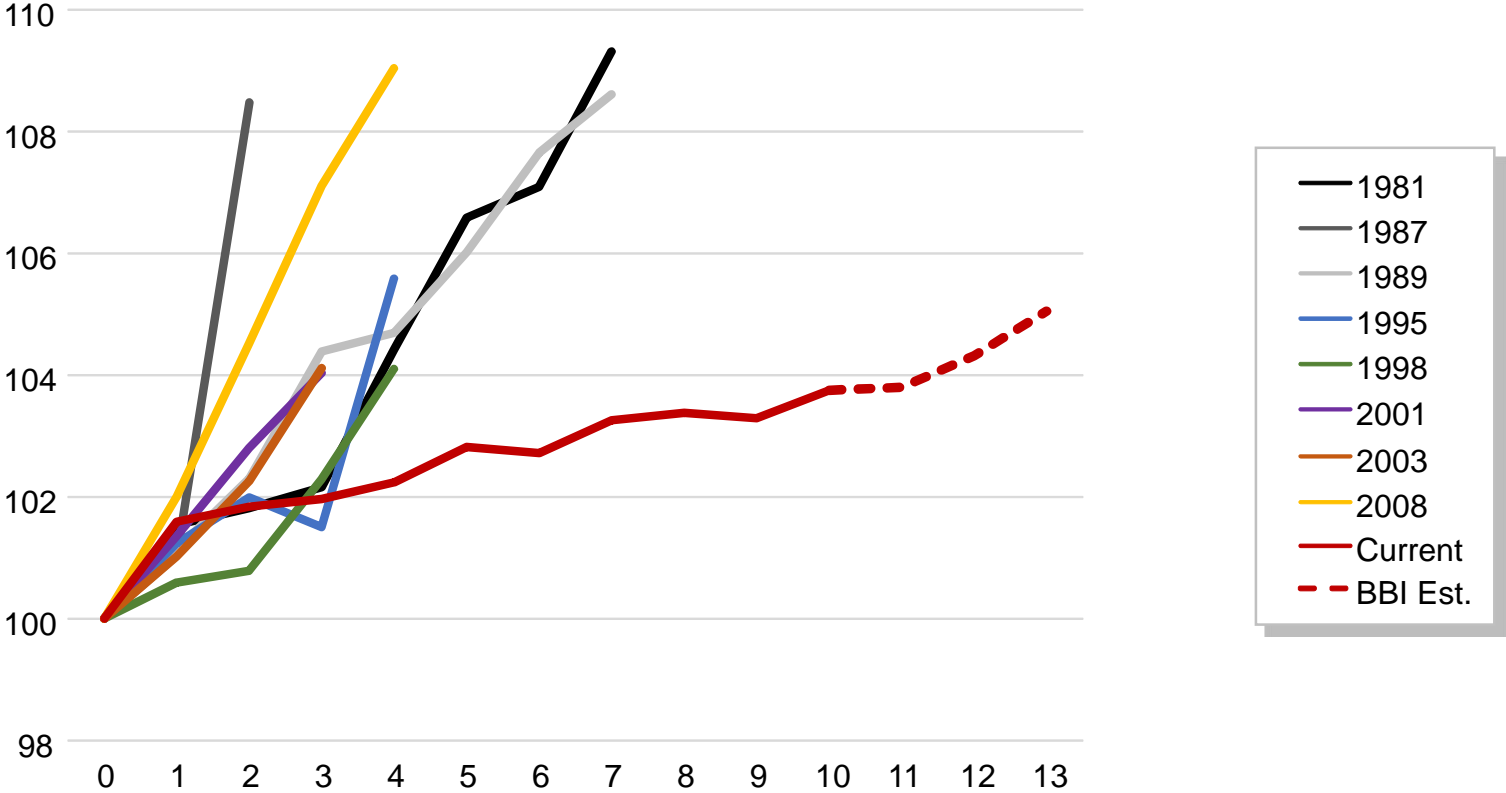
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# Multi-Year Earnings and GDP Growth Cycle

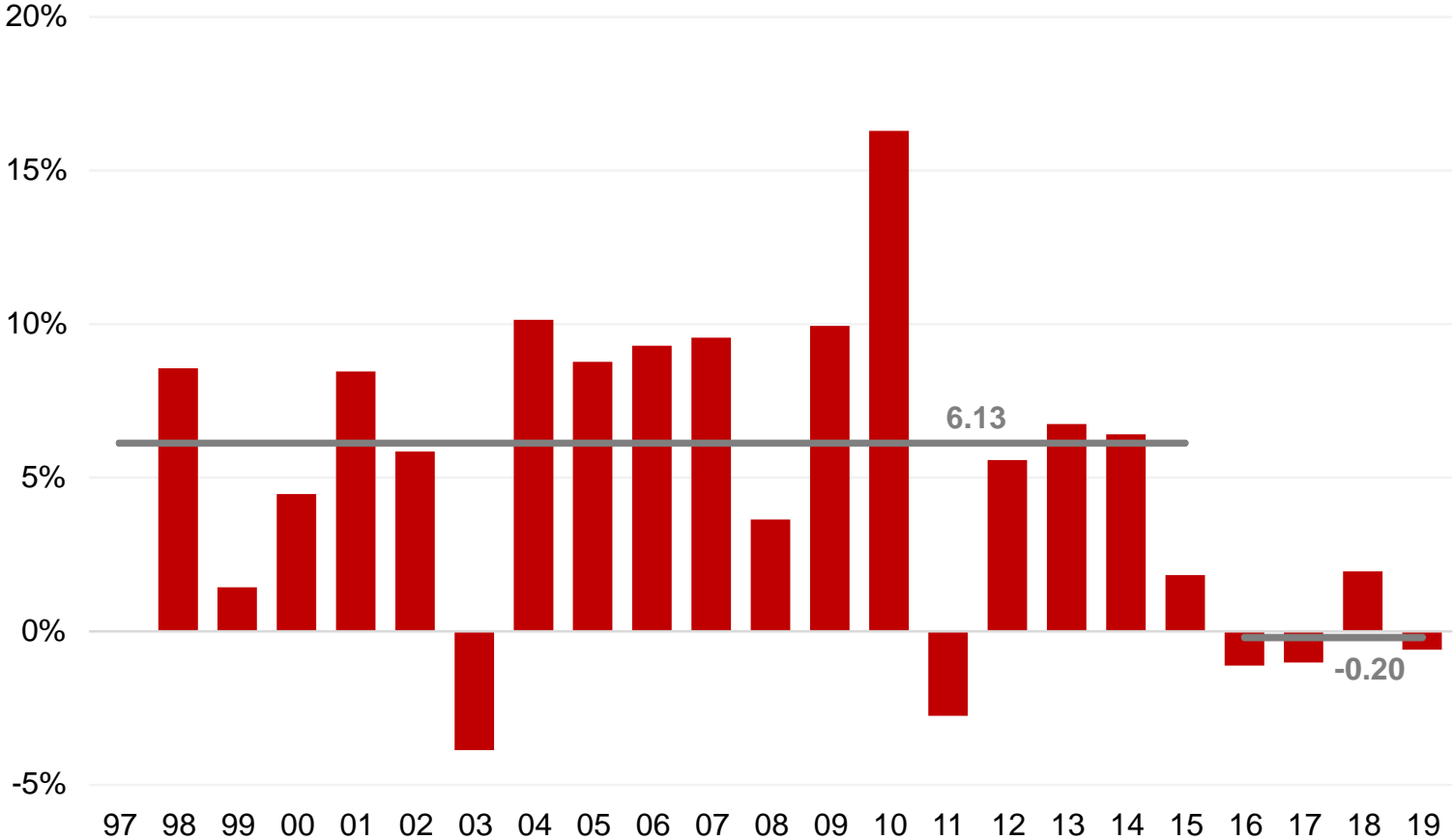
# Brazil GDP's pace of recovery after a recession is the slowest since 1980

Pace of GDP growth after recessions



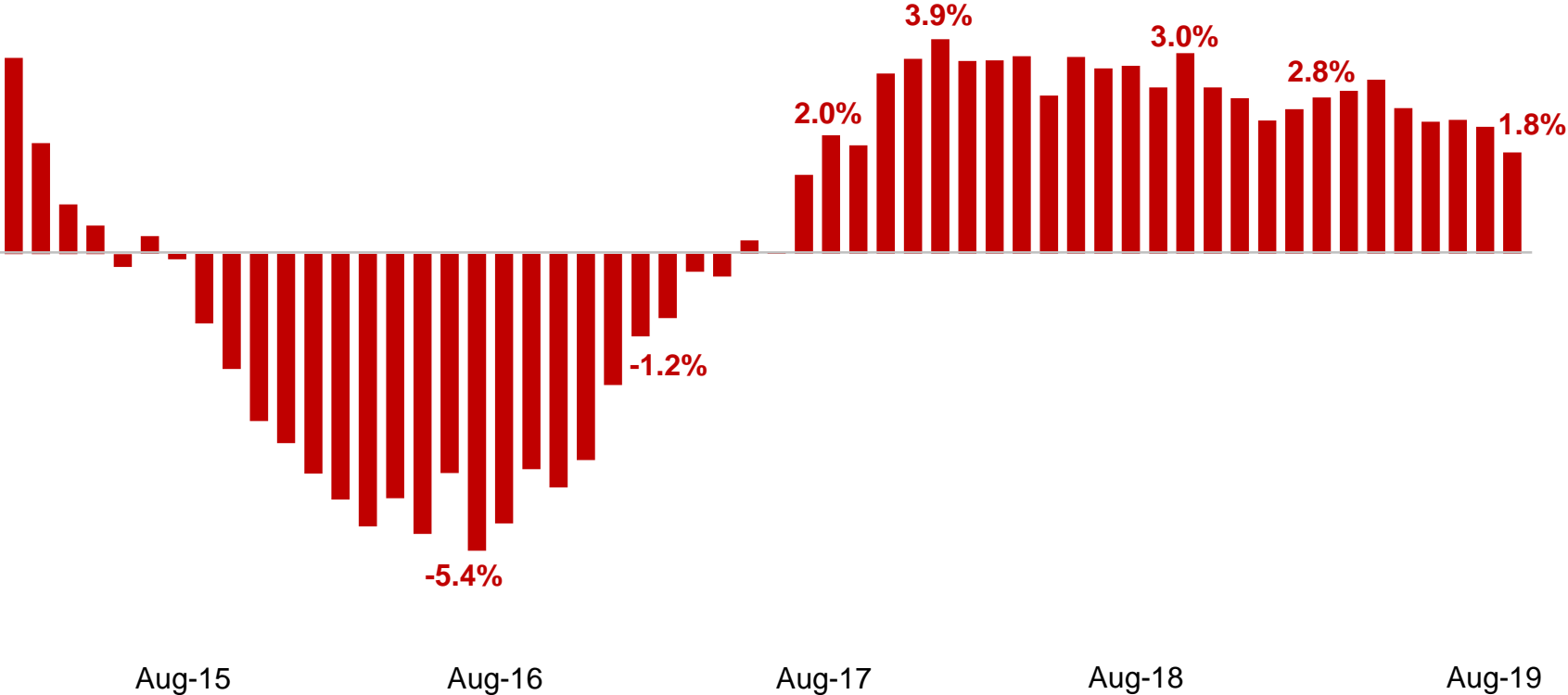
# In real terms, government spending is actually declining YoY

Central Government Real Spending (% annual)



# Real wage bill (wages + employment) provides cushion for household consumption growth

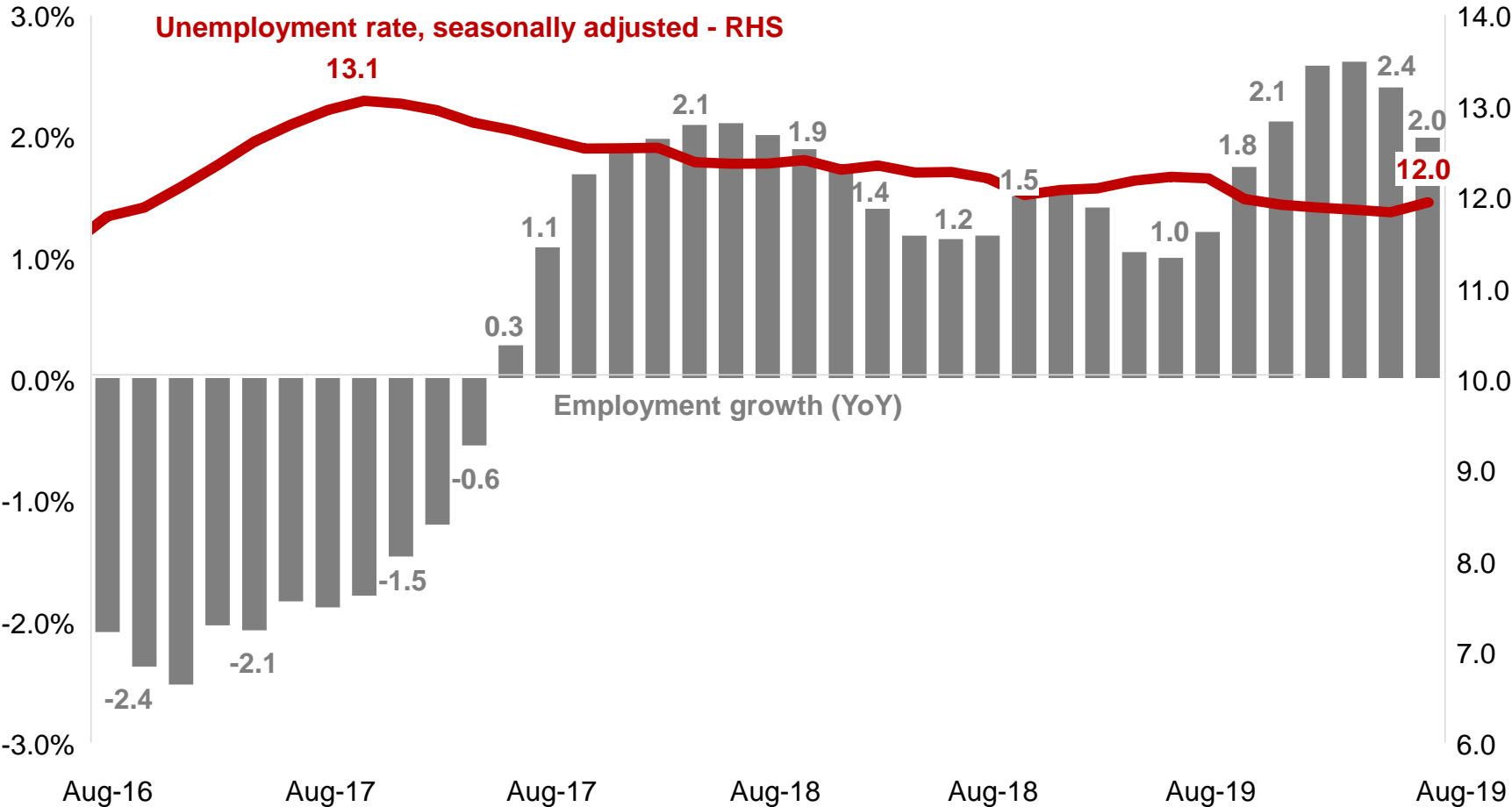
Real Wage Bill (YoY)





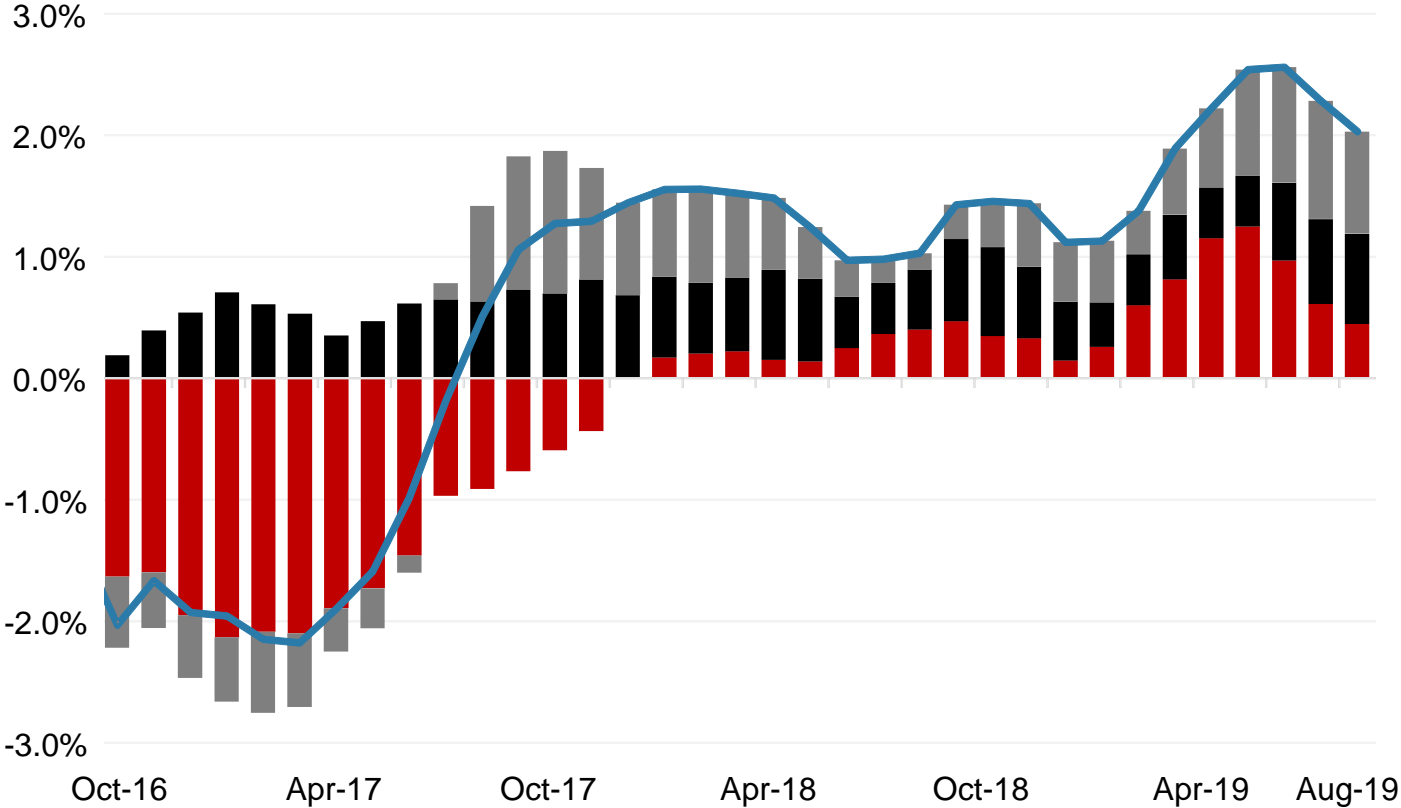
# Unemployment remains high

Employment growth (YoY %) and unemployment rate (%)



# Employment growth mostly driven by informal job creation

Employment growth breakdown (YoY)



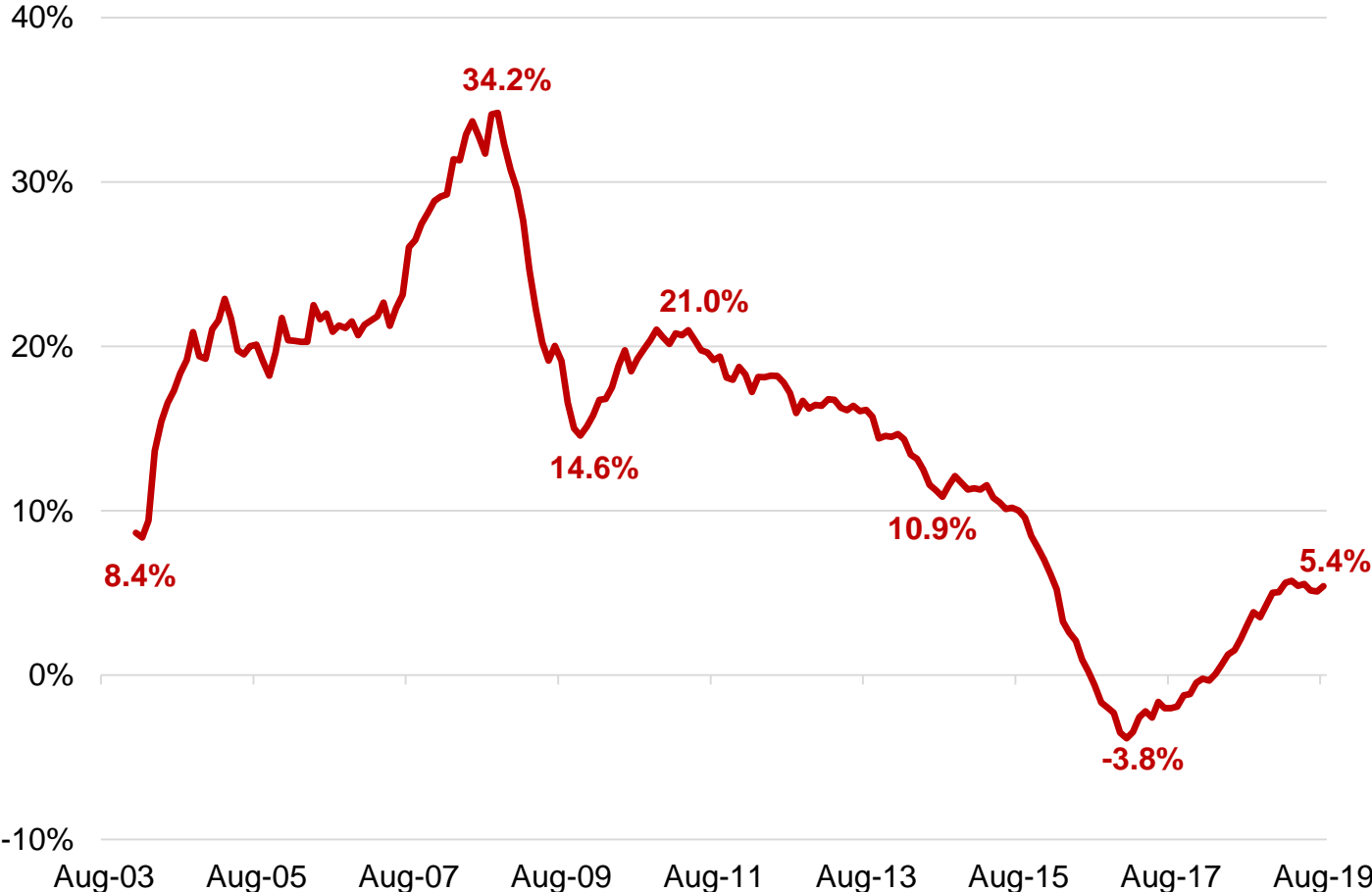
- Formal Jobs
- Informal Jobs – Private Sector Not Registered
- Informal Jobs – Own Business
- Total

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# Bank Lending Accelerating

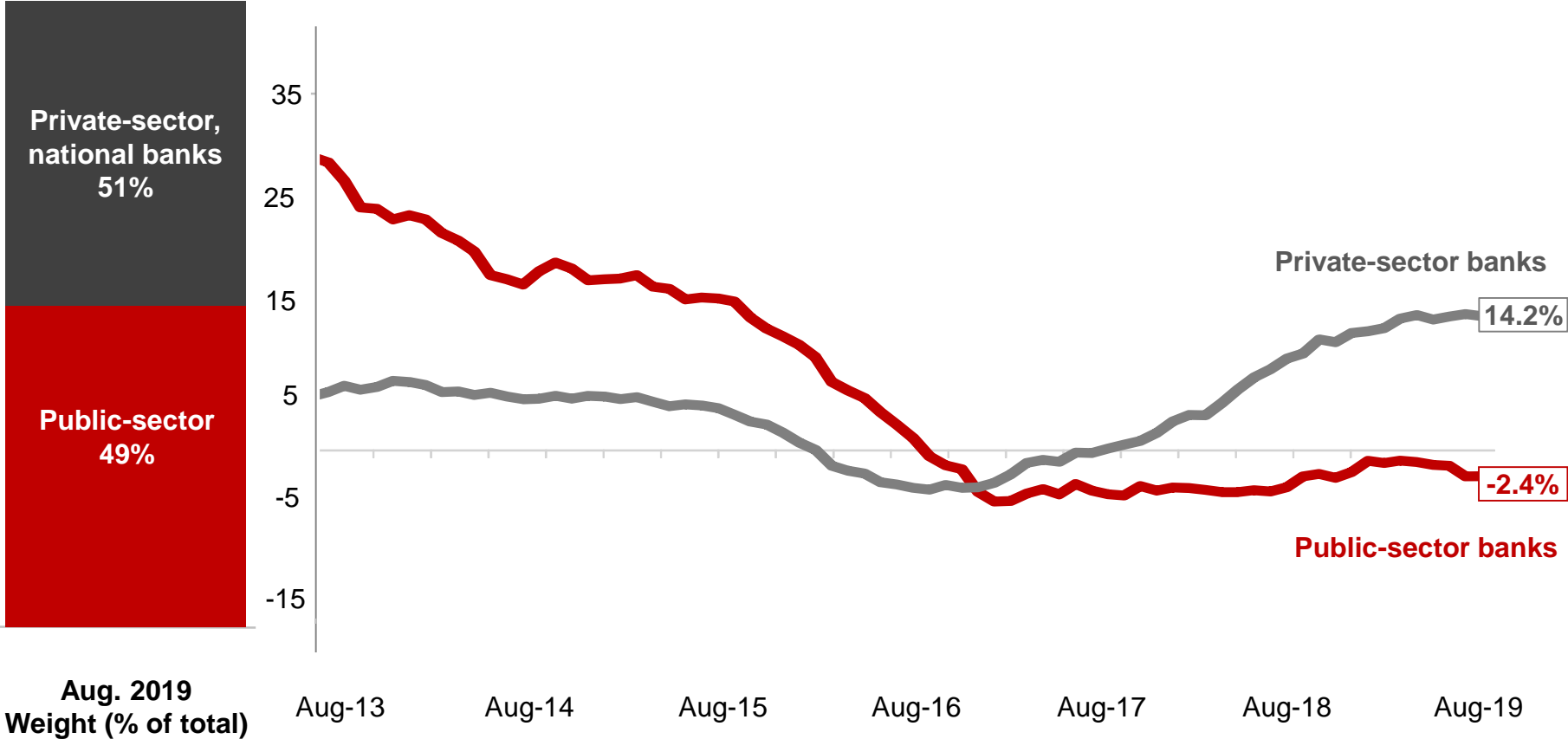
# Bank lending growth on an upward trend since early 2017

Bank lending growth in nominal terms (%)



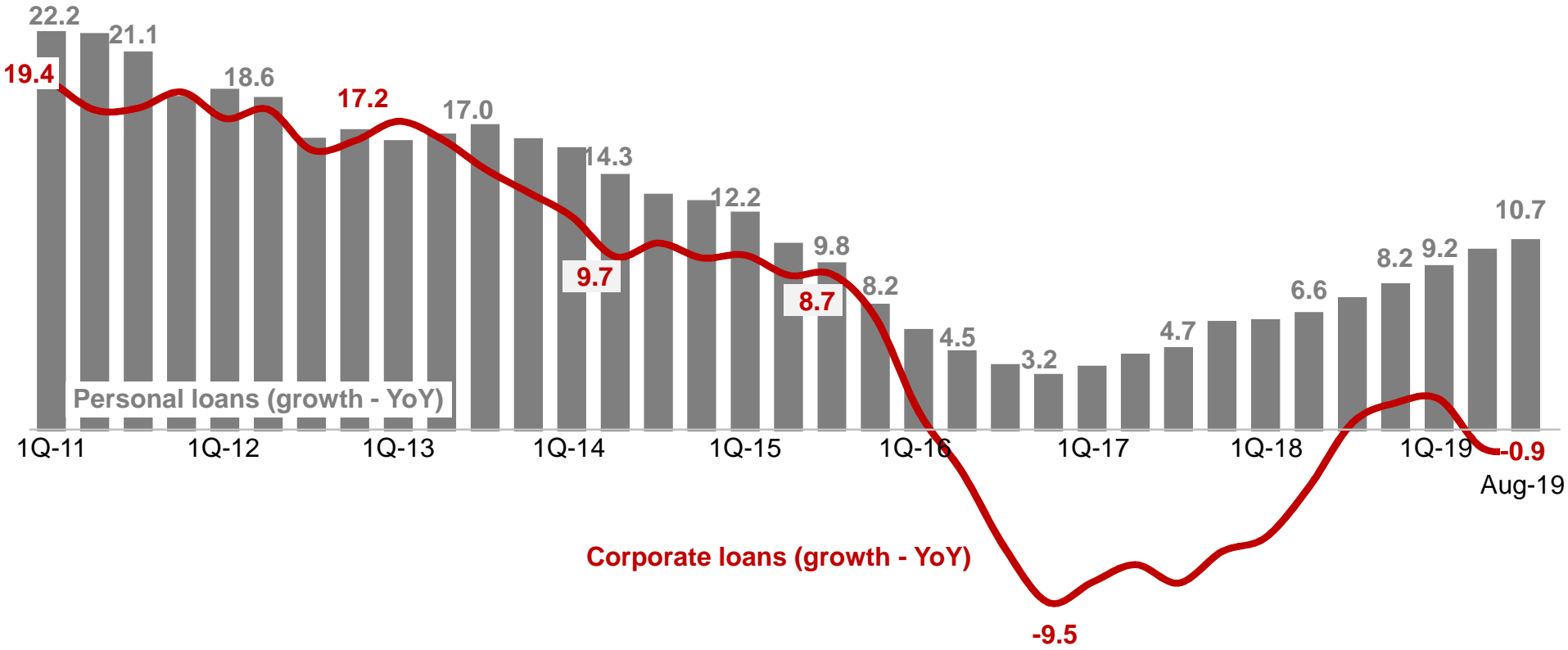
# Private-sector banks to continue gaining market share in 2019

Bank lending growth (YoY, %) and market share in Aug. 2019



# Bank lending still better for individuals than for companies

Quarterly Growth of Loans (%)



# Main investment themes

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- I. Global factors: Global economy in soft landing, Chinese domestic demand to stabilize & recover, US politics
- II. Brazil macro policy adjustment
- III. Low interest rates on multi-year basis
- IV. Multi-year GDP growth cycle
- V. Privatization, concessions, asset sales & turnaround of SOEs

# Sector recommendations

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## **Overweight**

Consumer Discretionary, Exchanges, Healthcare, Utilities

## **Neutral**

Energy

## **Underweight**

Cons. Staples, Banks, Industrials, Insurance, Materials, Real Estate, Telecom



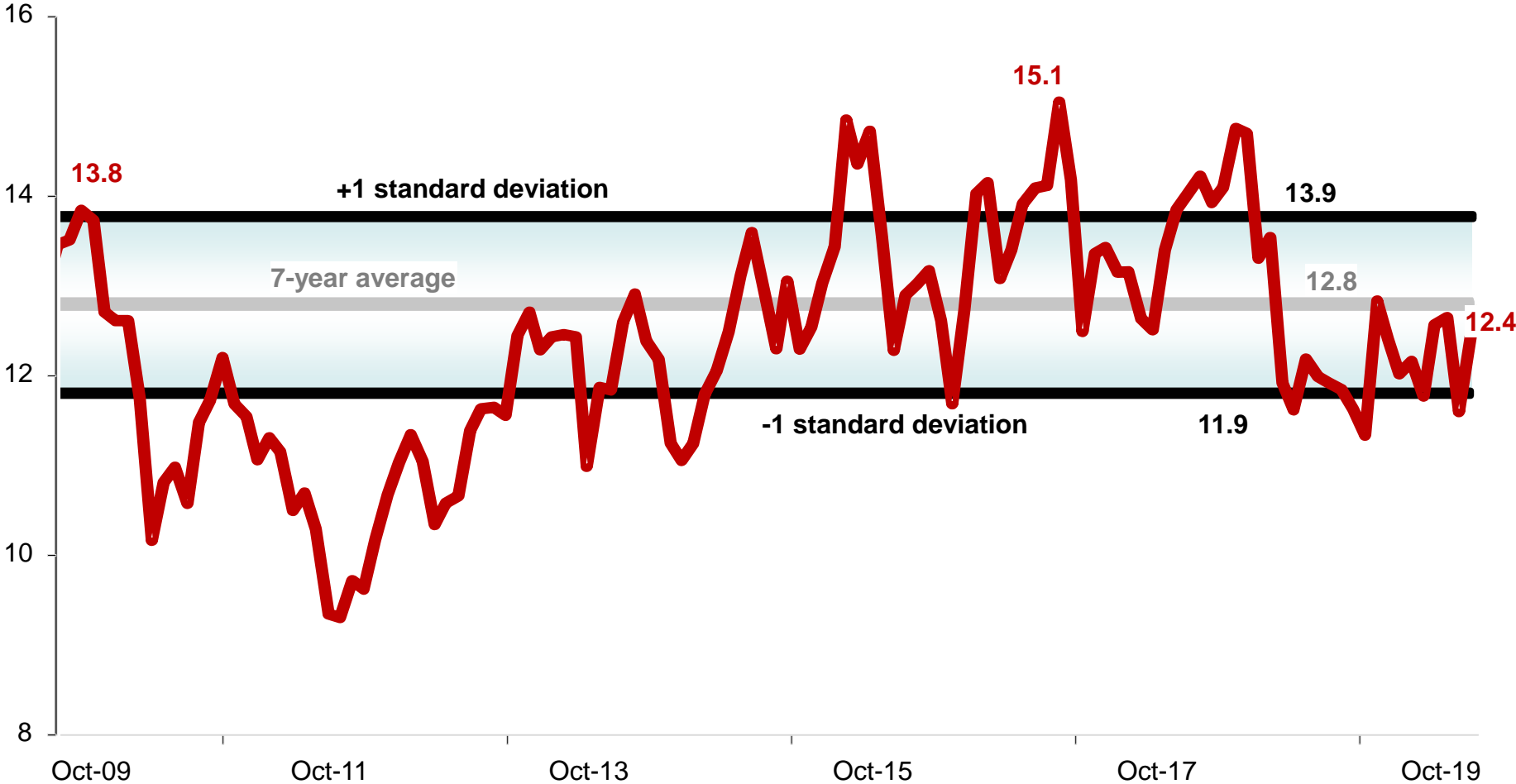
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## LatAm Equities

# LatAm equities are inexpensive

MSCI LatAm - Consensus 12-month forward P/E (through Oct. 16, 2019)



## We are OW Brazil and Mexico and UW Andeans and Argentina

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**Brazil (Overweight).** The Brazilian equity market looks cheap, considering the current long-term real interest rate and BBI's forecast for EPS growth. We see low risk of political fatigue regarding the current economic agenda. Our 2019 Ibovespa target is 122,000 points.

**Mexico (Overweight).** We see upside risks from more orthodox policymaking. This policy optionality, coupled with low investor sentiment, makes us comfortable in having an OW on the country.

**Chile (Neutral).** Although Chile has an attractive valuation, the country is exposed to China's economic performance.

**Peru (Underweight).** Disappointing economic activity figures, increasing political uncertainty, and high sensitivity to commodities & China support a more cautious view.

**Colombia (Underweight).** Despite Colombian equities' attractive valuations and high risk premiums, it is difficult to find appealing bottom-up stories.

**Argentina (Underweight).** The challenges are mounting and we have no visibility on the country's post-election macro policy. Also, BBI's economics team forecasts a deep recession in 2020 and a sharp currency depreciation, supporting our OW.

# Bradesco BBI's LatAm Model Portfolio

Through Oct. 16, 2019

Company	Local Ticker	MSCI Weight	Portfolio Weight	Bradesco BBI Rating	Mkt. Cap (US\$ mn)	Last Price	P/E 20E	Div. Yld (%) 19-20E	Fundamental Analyst
<b>Brazil</b>		<b>62.4%</b>	<b>67.8%</b>	<b>Overweight</b>					
Banco do Brasil	BBAS3	1.5%	6.0%	Neutral	30,984	45.00	6.8	5.6%	Victor Schabbel
Itau Unibanco	ITUB4	6.1%	10.0%	Neutral	76,216	34.86	10.8	6.2%	Victor Schabbel
B3	B3SA3	3.5%	6.5%	Outperform	22,365	45.20	24.0	4.2%	Rafael Frade
CVC	CVCB3	0.0%	6.0%	Outperform	1,899	53.00	19.5	1.2%	Richard Cathcart
Lojas Renner	LREN3	1.5%	7.0%	Outperform	9,904	51.83	26.7	1.7%	Richard Cathcart
Energisa	ENGI11	0.3%	6.0%	Outperform	4,451	47.80	17.9	1.7%	Francisco Navarrete
CPFL	CPFE3	0.0%	5.2%	Outperform	8,819	31.85	12.4	3.9%	Francisco Navarrete
Rumo	RAIL3	1.0%	6.2%	Outperform	9,792	23.47	29.4	0.4%	Victor Mizusaki
Vale	VALE3	5.8%	6.0%	Outperform	59,427	46.80	6.2	7.3%	Thiago Lofiego
Petrobras PN	PETR4	7.6%	9.0%	Outperform	92,125	27.93	11.6	3.9%	Vicente Falanga
<b>Mexico</b>		<b>21.2%</b>	<b>21.8%</b>	<b>Overweight</b>					
Banorte	GFNORTEO	2.3%	4.3%	Outperform	16,288	108.43	8.1	5.8%	Rafael Frade
Bolsa Mexicana	BOLSAA	0.0%	3.0%	Outperform	1,143	36.99	14.6	5.1%	Rafael Frade
Coca-Cola FEMSA	KOF	0.5%	4.0%	Outperform	13,021	61.98	16.9	3.3%	Leandro Fontanesi
Fibra Danhos	DANHOS13	0.0%	3.7%	Outperform	2,152	28.85	10.6	8.9%	Victor Tapia
GAP	PAC	0.6%	3.7%	Outperform	5,650	100.72	17.6	4.7%	Rodolfo Ramos
Cemex	CX	0.9%	3.3%	Outperform	6,189	4.13	9.5	1.7%	Rodolfo Ramos
<b>Chile</b>		<b>8.2%</b>	<b>8.2%</b>	<b>Neutral</b>					
Copec	COPEC	0.6%	3.9%	Outperform	13,080	7,214	24.3	2.2%	Thiago Lofiego
Enel Chile	ENELCHIL	0.4%	4.3%	Neutral	6,765	70.12	10.6	6.0%	Francisco Navarrete
<b>Peru</b>		<b>3.1%</b>	<b>2.1%</b>	<b>Underweight</b>					
Credicorp	BAP	2.2%	2.1%	Neutral	16,692	209.28	11.1	3.4%	Rafael Frade
<b>Colombia</b>		<b>3.4%</b>	<b>0.0%</b>	<b>Underweight</b>					
<b>Argentina</b>		<b>1.6%</b>	<b>0.0%</b>	<b>Underweight</b>					

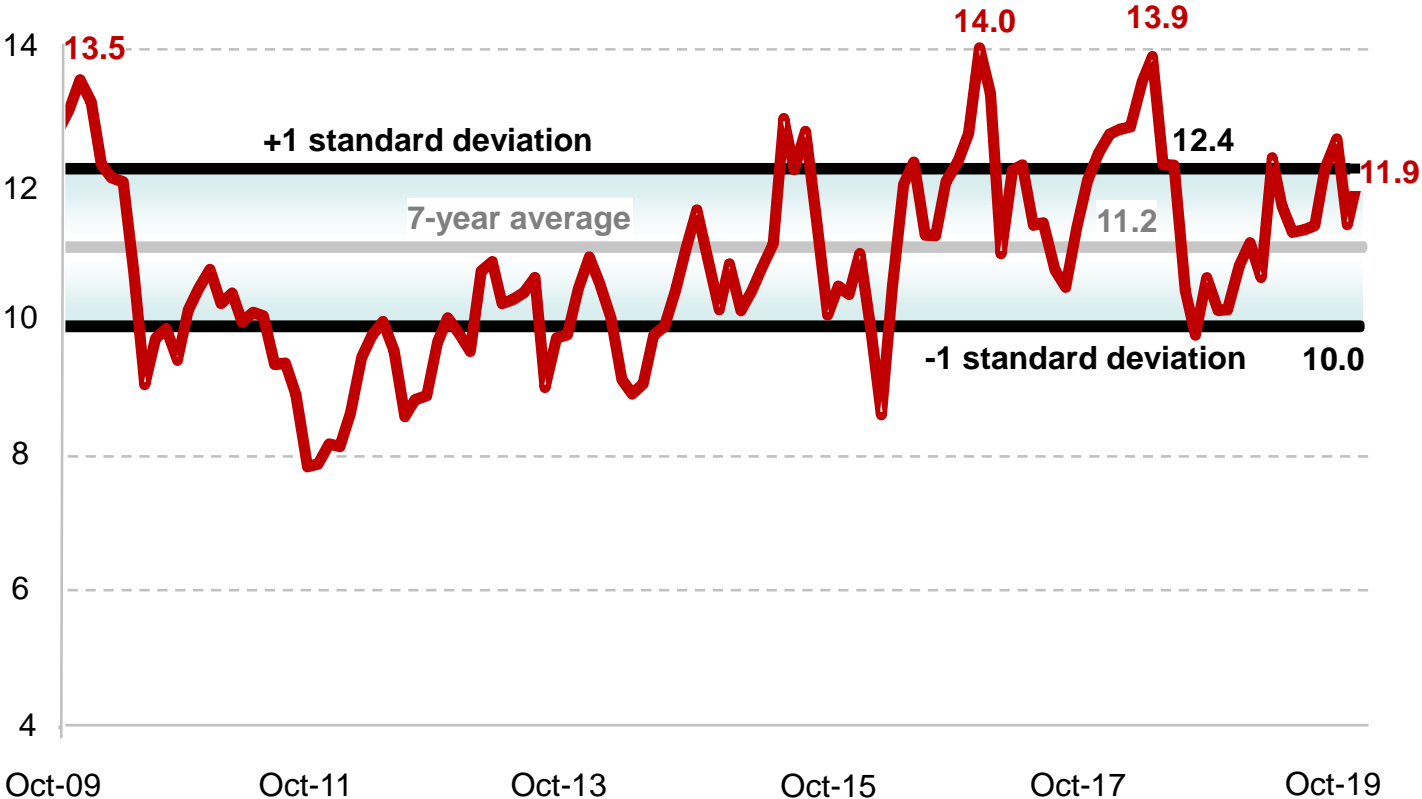
Note: The MSCI weighting for Petrobras considers the two classes within the Index. Source: Thomson Reuters Datastream, Bloomberg, Bradesco BBI

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# Brazilian Equities Outlook

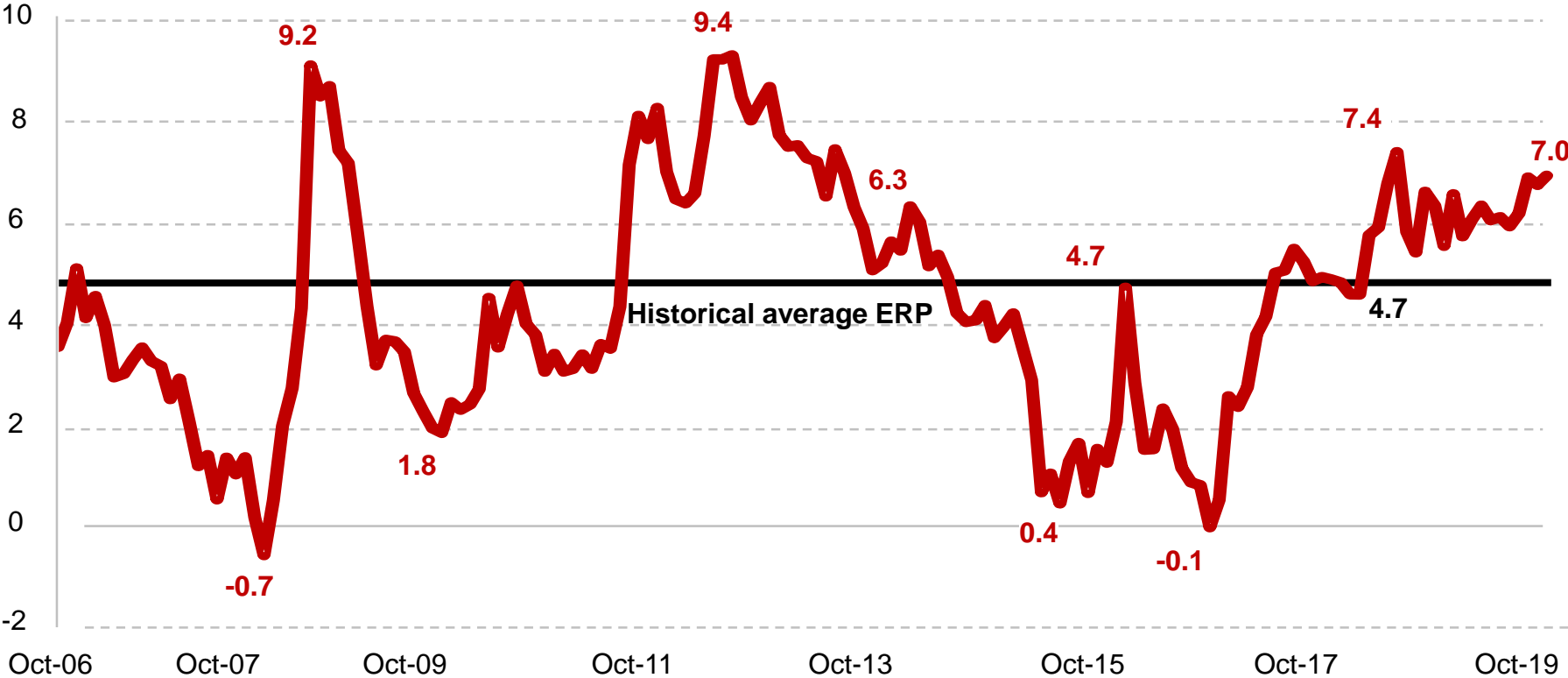
# MSCI Brazil multiples should be at 13.5x to reflect lower long-term rates

MSCI Brazil - Consensus 12-month forward P/E (through Oct. 16, 2019)



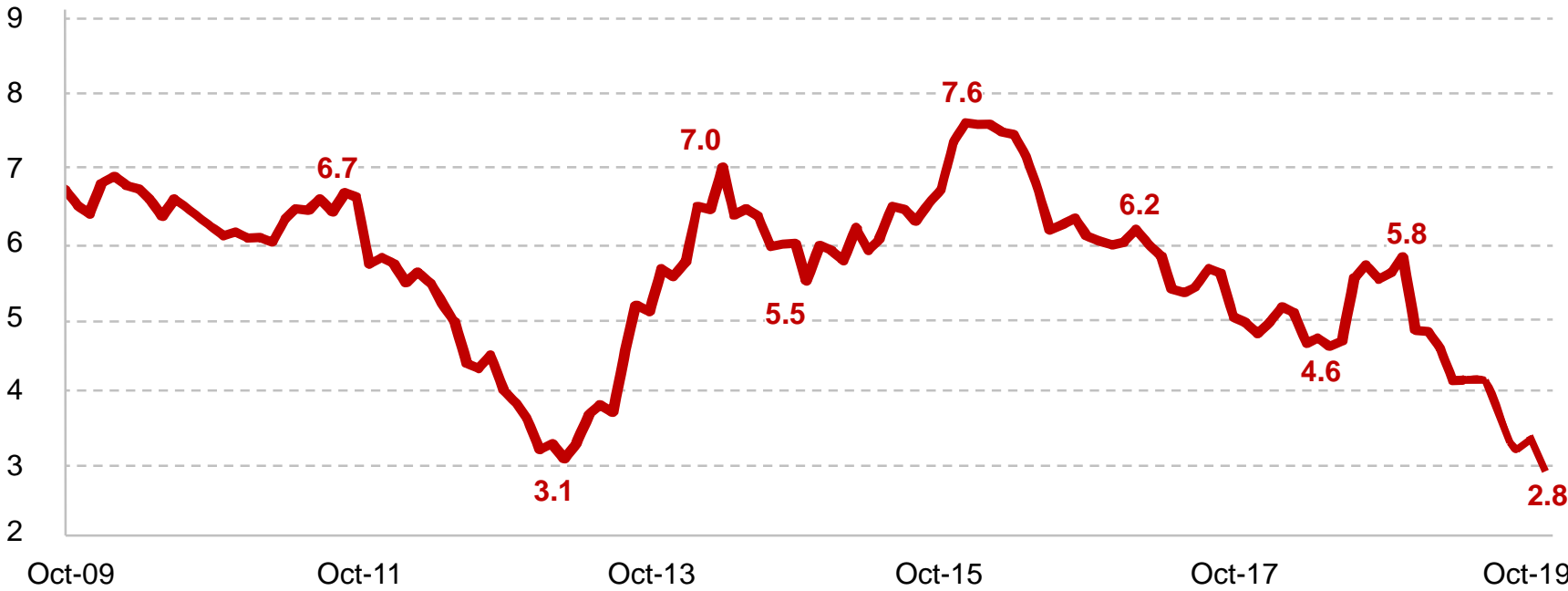
# MSCI Brazil embeds high equity risk premium (ERP)

Equity risk premium (ERP) and its historical average (p.p.) (through Oct. 16, 2019)



# Long-term real rates have decreased by 3 p.p. in the past year

NTN-B inflation-linked bonds' real yields (7-10 years\*, %, through Oct. 16, 2019)



Note: The index provides a weighted average yield of NTN-B bonds (IPCA inflation linked) issued by the Brazilian National Treasury with a remaining life of 7-10 years. The weights are given by the amount outstanding of each bond included in the basket. Source: Bloomberg, Bradesco BBI



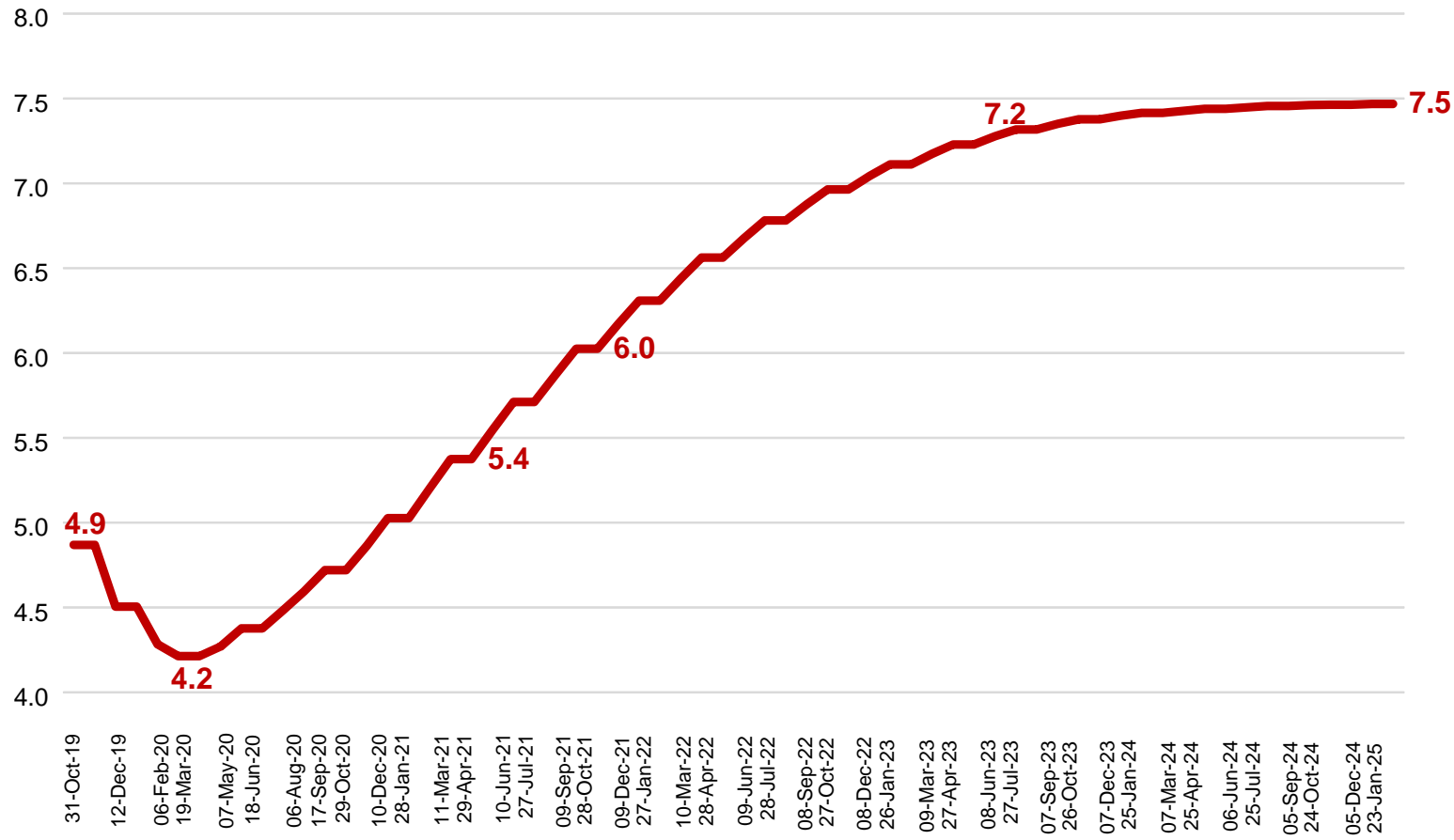
# Brazil's long-term rates converging to international peers' levels

## Nominal Interest Rates - 10 Years

	2008	2010	2015	2018	2019	CPI Target
<b>Brazil</b>	<b>12.5</b>	<b>12.3</b>	<b>13.7</b>	<b>10.3</b>	<b>7.2</b>	<b>3.8</b>
South Africa	9.1	8.5	8.2	8.7	9.0	4.5
Russia	7.9	7.8	11.3	7.8	7.2	4.0
Chile	6.7	4.8	4.5	4.2	2.7	3.0
Colombia	10.8	4.9	7.5	6.6	6.0	3.0
Peru	7.3	5.9	6.4	5.6	4.2	2.0
Mexico	8.4	7.0	6.0	7.2	7.0	3.0
Average (ex-Brazil)	8.9	7.7	8.2	7.2	6.2	3.3

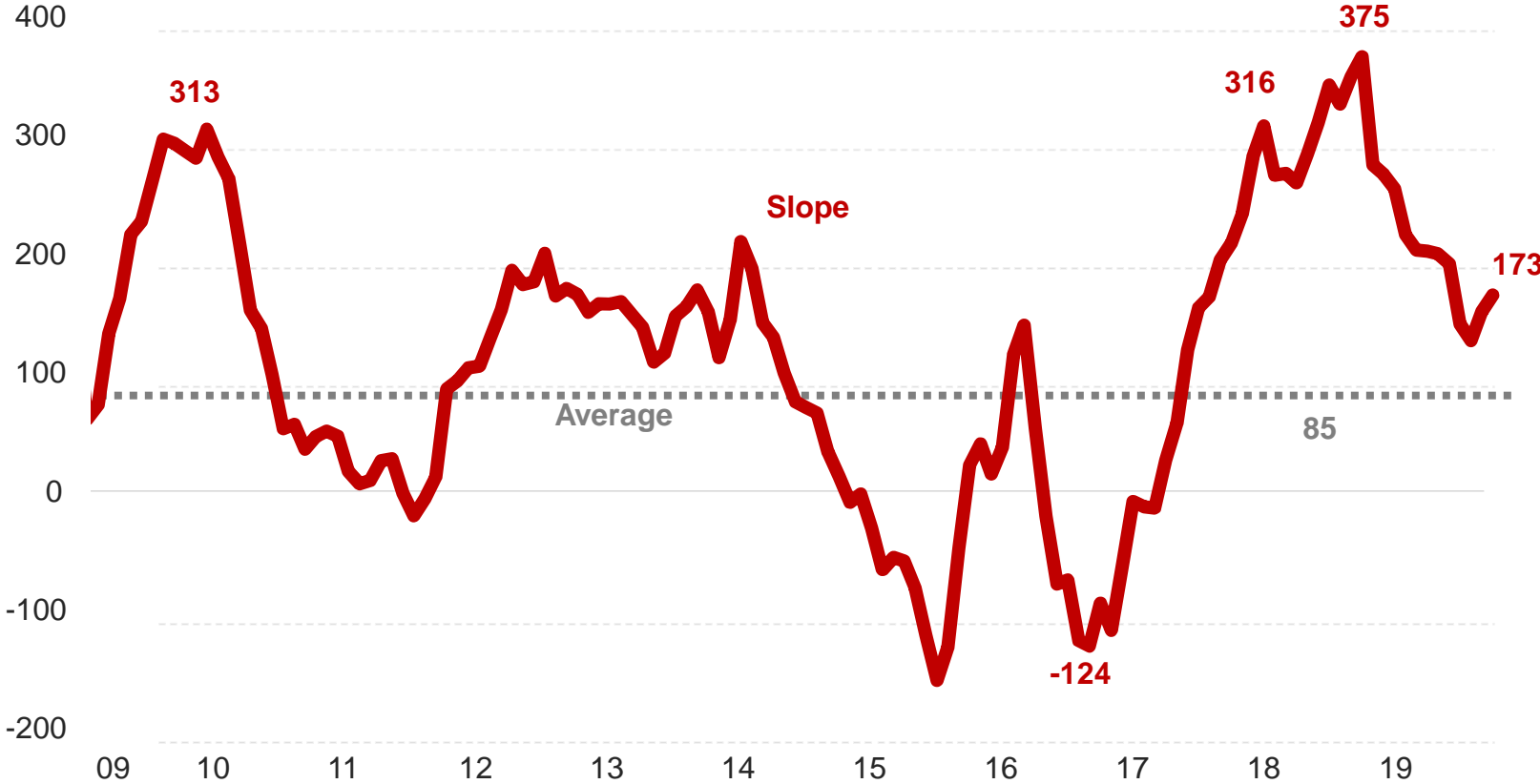
# Yield curve pricing in Selic at 4.0-4.5% soon, then low rates for long

Brazil's yield curve



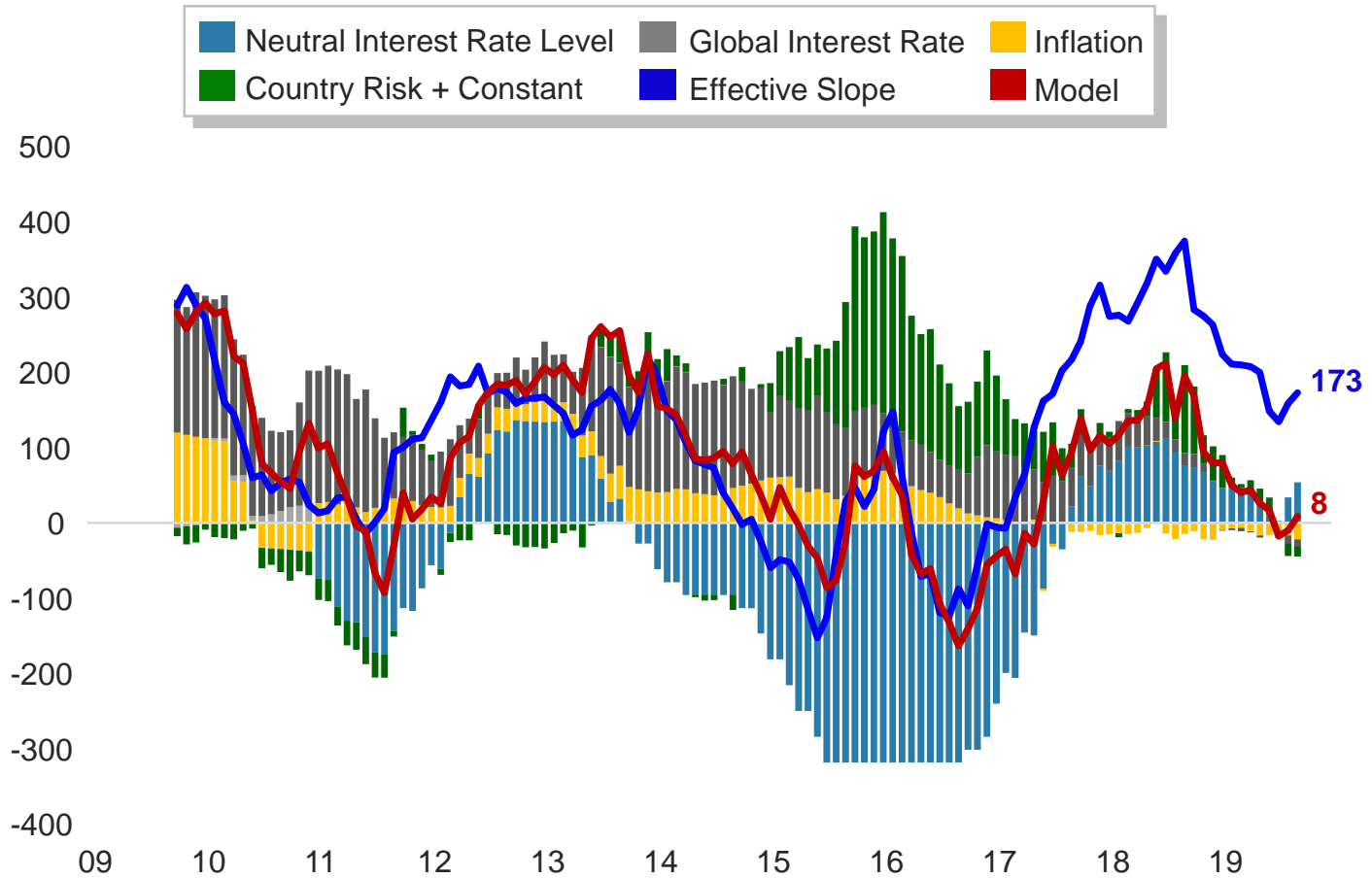
# Yield curve slope still above historical average...

Yield Curve Slope (bps) - Difference between 5-year and 1-year yields



# ...also above what fundamentals suggest due to fiscal uncertainty

## Yield Curve Slope - Breakdown



# Corporate credit spreads already reflecting much better macro in Brazil

Spread between corporate and sovereign credit yields (through Oct. 16, 2019)



# Bradesco BBI's Brazil Model Portfolio

Through Oct. 16, 2019

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Banco do Brasil	BBAS3	2.3%	8.0%	Neutral	30,984	116.3	45.00	6.8	5.6%	Victor Schabbel
Santander Brasil	SANB11	1.1%	15.0%	Outperform	42,177	18.0	46.37	10.3	5.1%	Victor Schabbel
B3	B3SA3	5.6%	10.0%	Outperform	22,365	94.7	45.20	24.0	4.2%	Rafael Frade
CVC	CVCB3	0.0%	10.0%	Outperform	1,899	22.7	53.00	19.5	1.2%	Richard Cathcart
Lojas Renner	LREN3	2.4%	8.0%	Outperform	9,904	46.4	51.83	26.7	1.7%	Richard Cathcart
Hapvida	HAPV3	0.0%	8.0%	Outperform	10,065	25.4	57.09	31.7	0.9%	Fred Mendes
CPFL Energia	CPFE3	0.0%	10.0%	Outperform	8,819	23.4	31.85	12.4	3.9%	Francisco Navarrete
Sabesp	SBSP3	1.0%	10.0%	Neutral	8,481	32.6	51.64	10.6	2.1%	Francisco Navarrete
VALE	VALE3	9.2%	8.0%	Outperform	59,239	53.4	46.80	6.2	7.3%	Thiago Lofiego
Petrobras PN *	PETR4	12.1%	13.0%	Outperform	92,125	285.5	27.93	11.6	3.9%	Vicente Falanga

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# Fiscal Adjustment

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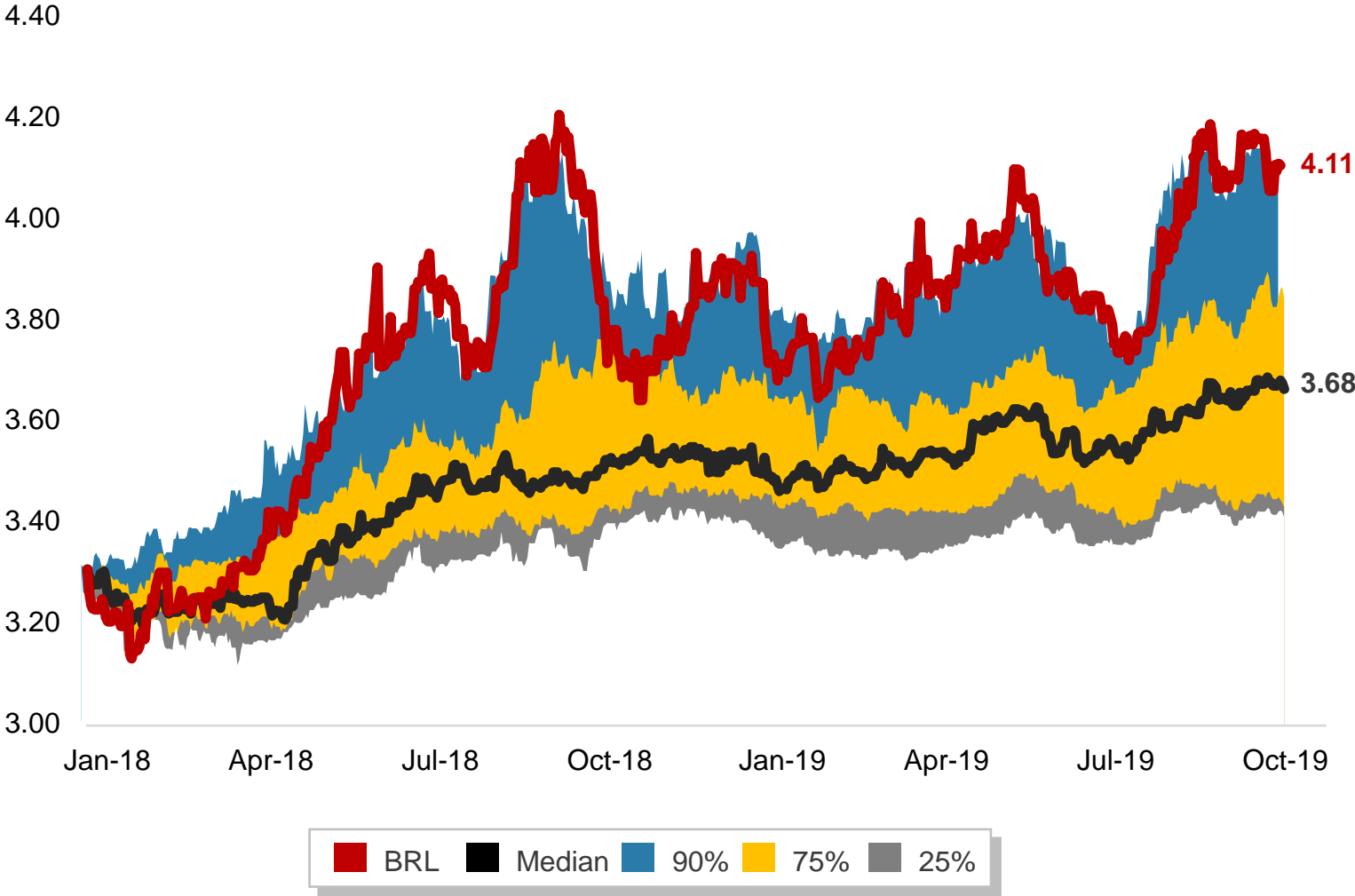
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## **BRL Trading at a Premium**



# The BRL has depreciated much more than other EM currencies

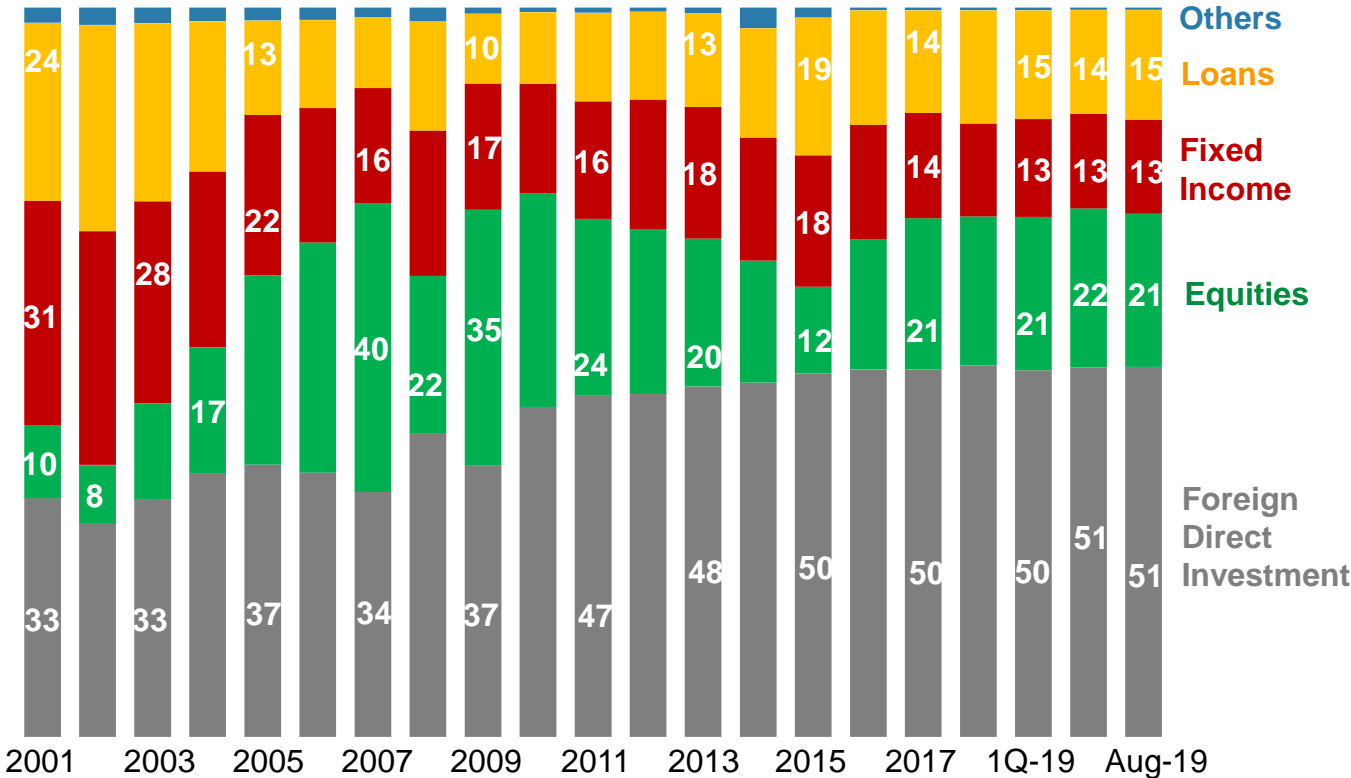
## BRL vs. 22 Emerging Markets' Currencies



Note: BRL accumulated change vs. median of 22 emerging market currencies  
Source: Bloomberg, Bradesco DEPEC, Bradesco BBI

# Net external liabilities suggest fair value for BRL close to R\$4.00/US\$

Breakdown of external liabilities (%)



# Risks to Brazil's equity markets in 2019 and 2020

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## Positive risks

- ☑ Congress to approve meaningful fiscal adjustment measures after passing the Pension Reform.
- ☑ Average Selic rate below 6% in 2019-2022 with Brazil's GDP accelerating.
- ☑ Earnings growth above consensus in 2020 and beyond.
- ☑ Deeper SOE turnarounds (e.g. privatization).
- ☑ International commodity prices rising with China's domestic demand recovering.
- ☑ Global risk appetite increasing.

## Negative risks

- ☑ Brazil's GDP growth remaining around 1%.
- ☑ Hard landing by global economy.
- ☑ Global geopolitical risk deteriorating materially.
- ☑ Significant decline in international investors' risk appetite, material slowdown in China, and sharp drop in commodity prices.