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Market views and strategy

Ostrum
ASSET MANAGEMENT

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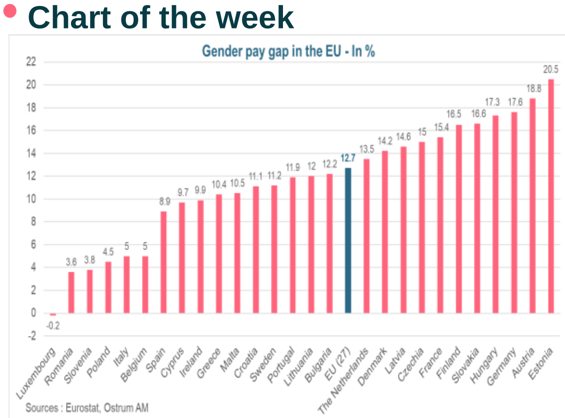
Topic of the week: Brazil: Heading towards the «BBB»!

- **Brazil is entering a major structural macroeconomic shift;**
- **Its strong agricultural capacity allows it to rapidly improve its external position;**
- **Its main asset is its central bank, which strengthened its credibility after the Covid-19 crisis;**
- **Tax and fiscal reforms are important milestones in the country's economic agenda;**
- **Long a major player in hydroelectricity technologies and biofuels, Brazil wants to be a «green» power in hydrogen and other low-emission solutions.**

Market review: Early Christmas

- **Us inflation (3,2 %) comes in below expectations in October;**
- **Fed: markets expect 50 bp of easing in the first half of 2024;**
- **Widespread rally in risky assets amid dollar weakness;**
- **Sovereign spreads resume their decline.**

Chart of the week



Women earn 13% less than men in the European Union, according to Eurostat. This gap stabilized in 2021 and has only narrowed slowly before. Equal Pay Day (the date that symbolizes the number of extra days women must work until the end of the year to earn the same salary as men) is November 15. There are strong disparities. Among the large countries, the wage gap is very large in Austria (18.8%), Germany (17.6%) and France (15.4%) while it is relatively smaller in Italy (5%), in Belgium (5%) and in Spain (8.9%). However, it is necessary to put into perspective, in certain countries, a small gap may come from a lower employment rate of women and the arrival on the labor market of women with relatively higher incomes.

Figure of the week

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Source : Bloomberg

The Karlsruhe Court of Justice in Germany rejected the reallocation of €60 billion of unused Covid loans to the Climate and Transformation Fund, while they were exempt from the "debt brake" rule.

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Topic of the week

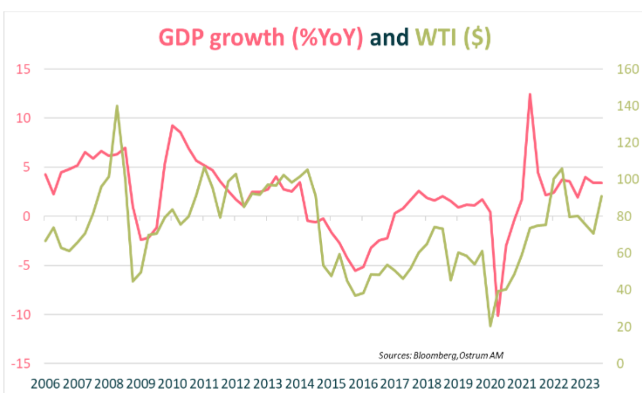
Brazil: Heading towards the «BBB»!

Investors have become optimistic about Brazil. This summer, Fitch raised the country's external sovereign rating to "BB", two notches below the "Investment grade" status that the country lost in 2016, when it experienced its worst recession since the Latin American debt crisis of the 1980s. The Brazilian government wants to turn this page and is embarking on a major structural macroeconomic shift.

Towards a major structural macroeconomic shift

The return of growth thanks to higher oil prices

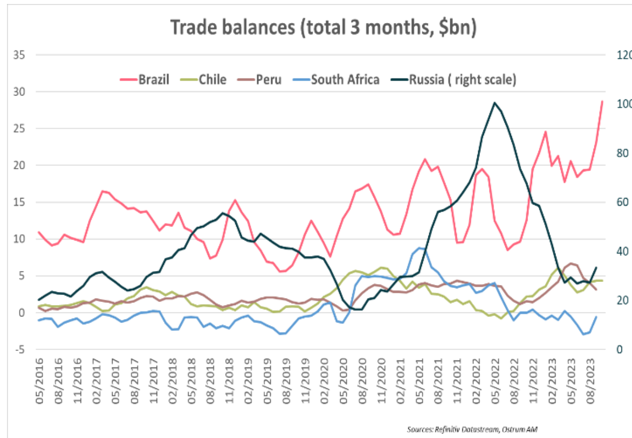
After registering strong growth during the commodity price cycle, Brazilian growth contracted by an average of 0.3% per year between 2014 and 2019. Brazil had experienced its worst recession in the 2014-2016 period, since the Latin American debt crisis of the 1980s, linked to the fall in commodity prices, notably those of oil, as shown in the chart below (data as at 29 September 2023).



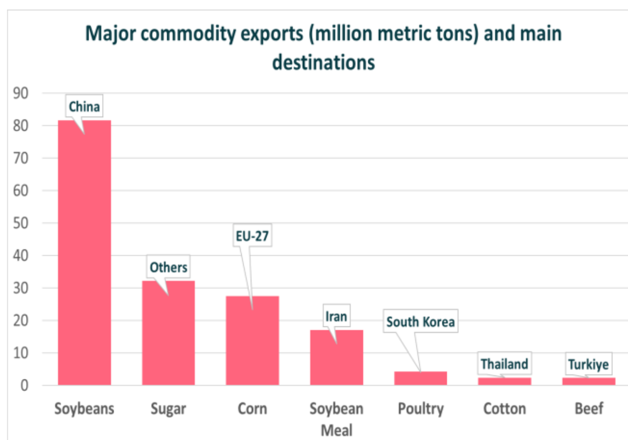
Brazilian GDP contracted by -3.6% in 2016, the second year of recession since 2015. The year 2016 was also marked by political instability and the loss of «Investment grade» status by Brazil. The country has since kept the external sovereign rating of Ba2/BB-/BB. The prospect of higher crude oil prices linked to geopolitics and the energy transition should support the Brazilian economy, allowing it to return to growth.

A Trade balance that makes envious!

If there is one aspect that stands out for Brazil compared to other commodity exporting countries, it is its trade balance as shown in the graph below.

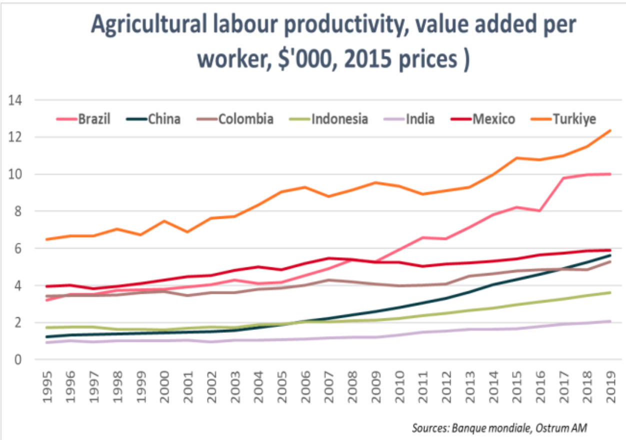


Over three months, Brazil's trade surplus reached an all-time high of $28.9 billion, led by the rapid increase in its exports of agricultural products. Indeed, Brazil is a major producer of raw materials. The graph below shows the country's main exports as well as the main destinations.



The rapid growth of Brazilian exports is due to China. In 2021, China accounted for 39% of Brazil's agricultural exports and 70% of the volume of its soybean exports. Soybean exports could contribute to 1/5th of Brazil's growth this year. Brazil also benefits from the reduction in Chinese imports of soybeans from the United States. The establishment of customs barriers by the United States and the Eurozone on their agricultural products, also allows Brazil to gain market share, especially towards emerging countries.

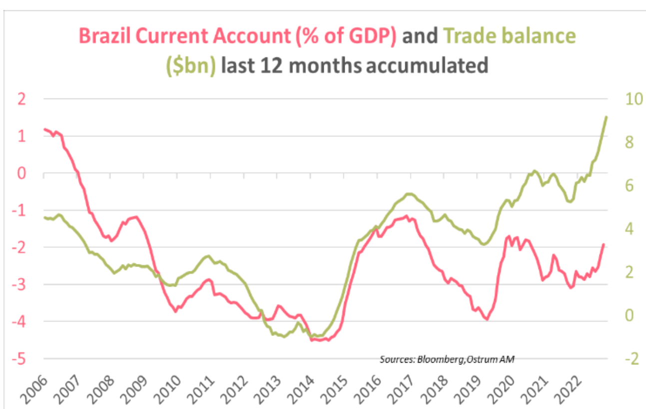
Nevertheless, agricultural productivity has not increased since 2017, as shown in the graph below.



This is a point that the government must improve to make sustainable the dynamic of exports in agricultural products.

A surplus of the current account, and voila!

In September 2022, the current account deficit was close to $7 billion. It fell rapidly in September to $1.375 billion, or 1.9% of GDP, linked to the rapid increase in the trade surplus, as shown in the chart below.

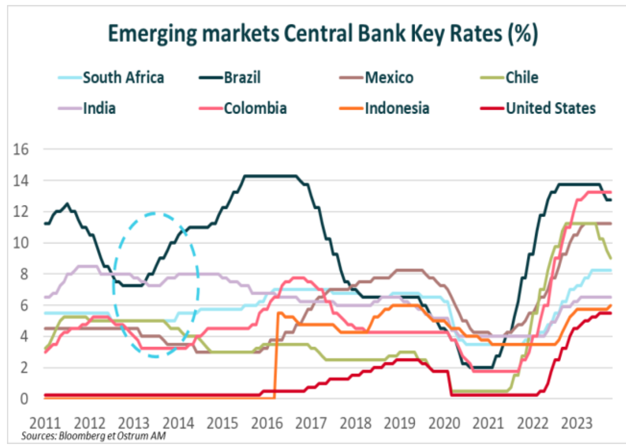


Despite the large surplus in the goods balance, however, the Brazilian current account remains in deficit as much of the agri-food sector is held by foreign interests. Foreign direct investment amounted to $3.75 billion, or 2.89% of GDP, to finance the current account deficit. This should not be long before the Brazilian current account balance is in surplus.

Brazil's strong asset: BACEN!

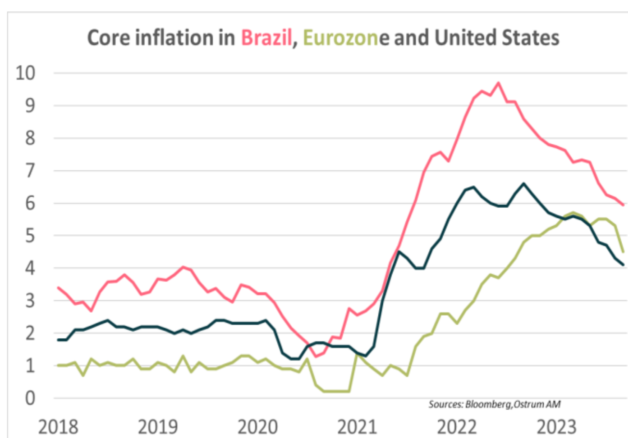
Enhanced credibility after the Covid crisis…

The credibility of the Central Bank of Brazil (BACEN) was strengthened after the Covid-19 crisis. It was the first central bank to raise its Selic rate before the Fed and other central banks in March 2021. On the chart below, we can also note that in 2013, during the episode of Taper Tantrum, BACEN was also the first to raise its key rate.



… Which is working!

The credibility of the Brazilian central bank is no longer a subject. The effect of monetary tightening was effective on inflation, which fell from 12% in April to 4.8% in September, right on target. Core inflation, 5.5% in October, slowed faster than other money markets as shown in the chart below.



This allowed BACEN to calmly lower its Selic Rate from 50 bp to 12.25%, reaping the benefits of its credibility. The appreciation of the real, also contributed to the moderation of inflation. The Brazilian currency is benefiting from the improved terms of trade. This is an important support factor for the Brazilian real.

Tax and fiscal reforms

President Lula has become more realistic and wants to turn the page on the worst recession of 2014-2016. His new finance minister, Fernando Haddad, has proposed two major reforms that could put Brazil back on track for sustainable growth. These are tax and fiscal framework reforms.

Tax reform: simplify taxes!

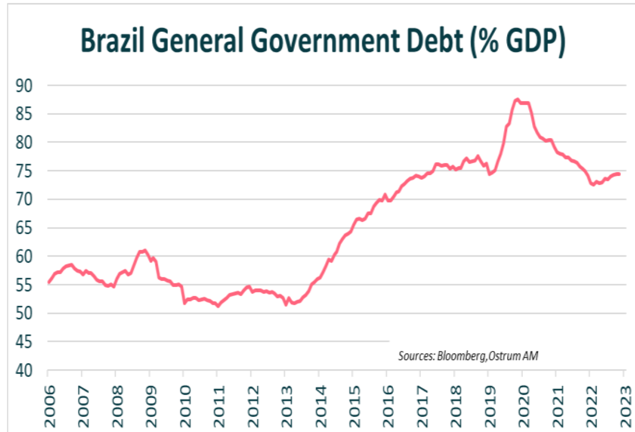
The Brazilian tax system is very complex because the 27 states and 5,000 municipalities set their own taxes! Tax lawyer Vinícios Leôncio has spent more than two decades compiling Brazil's tax laws. A book that weighs 15 tons, is seven feet tall and contains nearly 50,000 pages. It exists in real life and is exhibited in the state of Minas Gerais in a hotel room - the only place where the author found enough space to accommodate it! This is to show the complexity of the Brazilian tax system and the urgency to reform.

The tax reform will therefore combine 5 taxes on goods and services into two value-added taxes, one federal and one local. According to the Brazilian central bank, in the first year of its implementation, Brazilian GDP could grow by 1.5%! On November 8, the tax reform was approved by the federal Senate. The next step will be to send the final text back to the Chamber of Deputies, as changes were made to the original text during the reform approval process. This is an important step in Brazil's economic agenda.

A new fiscal framework

The fiscal framework will replace a rigid 2016 spending cap, which has been constantly broken, with a flexible rule. The new rule limits the federal government's increase in primary spending to 70% of the previous year's revenue growth, aimed at achieving a balanced primary budget (that is, before debt interest payments) next year and a primary surplus starting in 2025.

If the government does not meet its targets, spending growth will be reduced to only 50% of the revenue growth of the previous year and the government will not be allowed to increase the wages of public workers, among other restrictions. This should stabilize Brazil's gross public debt, which currently stands at 74% of GDP, as shown in the graph below.



Brazil: a «green» energy powerhouse

A few days before COP28, Brazil issued its first "green" bond for an amount of $2 billion and with a return of 6.5%, a rate lower than the initial rate of 6.8%. The "green" bond has succeeded a lot of interest because Brazil raised $6 billion. 50-60% of the funds will be used to finance green projects and 40-50% of social projects. The greater share given to the «green» success the enthusiasm of investors because it improves the «green» profile of Brazil which is bad compared to other emerging countries, especially because of the deforestation of the Amazon forest by the government of Bolsonaro.

Brazil is a major player in hydroelectric and biofuel technologies. The country is now looking to expand into hydrogen and other low-emission solutions. Renewable energy represents 80% of the electricity produced in Brazil. Hydroelectricity represents 65% of its electricity production. The Brazilian government plans to increase the share of solar energy (currently 3%) and wind energy (currently 11%). Wind power has the greatest potential in Brazil during the dry season and can be covered against low rainfall and the geographical distribution of existing hydroelectric resources.

Conclusion

Brazil is entering a structural shift. Its strong agricultural capacity, the credibility of its central bank, the reforms of its tax system and fiscal framework should allow the country to turn the page of its dark decade permanently by returning to a more sustainable growth. Its strong involvement in the fight against climate change should result in massive investments in low-emission technologies and in the preservation of the Amazon Forest. The country's efforts, which go in the right direction, should allow the country to regain its «investment grade» status. Boa sorte!

Zouhoure Bousbih

Market review

Early Christmas

The market wants to believe in a rapid easing of rates from the Fed. The decline in the dollar benefits risky assets.

The knee-jerk reactions of financial markets to economic data releases are often confusing. US inflation (3.2% in October), which came in lower than expected by 0.1 pp, was enough to anchor market expectations for a 50 bp reduction in the Fed funds rate from the first half of the year. The ECB would do the same according to market operators. In addition to the 10-year T-note's instant plunge below 4.50% and the Bund yield under 2.60%, the US dollar lost as much as 1.5% against all currencies whilst the Nasdaq gained 300 points. The dollar decline thus was a catalyst for improved investor sentiment and flows favorable to risky assets. Stock market volatility (VIX index) fell back to 13.8%. Markets then oscillated at high levels ignoring strong retail sales figures. The magnitude and asymmetry of market reactions are quite remarkable.

The US economy is showing no tangible signs of running out of steam. Indeed, job creation is slowing down, but the recovery in real wages may continue to fuel household consumption. The 0.1% decrease in retail sales in October must be nuanced as gasoline prices recorded a sharp drop and previous data was revised upwards. Household spending remains the basis of growth in the United States. However, residential construction is showing signs of weakness. Housing starts are lower than building permits and developer confidence plunges to 34 (November NAHB survey). The attrition of real estate supply remains a risk factor for inflation in 2024. Shelter costs, however, moderated in October (+0.3%) in the consumer price index. Furthermore, the fall in oil prices since early October reduces inflation and improves purchasing power. The European consumer should finally get a boost after a prolonged period of contraction in demand.

On the fixed income markets, the US CPI release sparked an instant plunge of 15 bp in the T-note yield to 4.45%. US Treasury yields are falling sharply across all maturities with an outperformance of the 5-year bonds, which reflects the directional nature of the downshift as market participants ignore Moody's' decision to lower the rating outlook for the United States. The Fed's pivot is already a reality for markets that forecast 50 bp worth of monetary easing by June. The T-note logically drags the Bund yield lower from a 2.70-2.75% range to 2.50-2.60%. Legitimate fears about the public finance situation have been put on hold so that all sovereign spreads are tightening. Italy broke through its 180 bp floor. Moody's surprisingly raised the outlook on Italy's rating to stable. Portugal bonds which were subject to profit taking after the resignation of PM Costa are once again trading at 2023 tights (64 bp). The easing in spreads started before Moody's upgraded the Portugal rating by two notches to A3. The hypothesis of an upgrade in the Portuguese rating seems to be called into question due to political instability. In terms of flows, we are seeing profit taking after the sharp narrowing of swap spreads. The latest EU syndication was very successful with some selling flows at the end of the week. Note that the German constitutional court rejected the government's request to redirect the remaining €60 billion from a support fund towards infrastructure spending. In inflation markets, oil's decline below $80 offers attractive entry points into short-term inflation breakevens just above 2%.

In the credit markets, the recent drop in swap spreads has had an impact on credit spreads. The balance of flows is improving for the asset class, particularly for intermediate maturity funds. Primary bond issuance is generally oversubscribed. New high-quality low-beta credit, however, is underperforming given the bullish backdrop. Flows into money market funds as the expected trajectory of short rates shifts lower. As for high yield, technical flows are improving with the support of flows and an upbeat CDS market. The drop in equity volatility implies a parallel tightening of iTraxx Crossover spreads (around 380 bps).

The stock market is the main beneficiary of the anticipated monetary relief. The sensitivity of stocks to long rates is reflected in an increase in multiples which erases recent disappointments in turnover. Small US stocks are benefiting from portfolio rebalancing after a long year of underperformance.

Axel Botte

Main market indicators

G4 Government Bonds	20-Nov-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	2.98%	-10	-14	+22
EUR Bunds 10y	2.59%	-12	-30	+2
EUR Bunds 2s10s	-39.1bp	-2	-16	-19
USD Treasuries 2y	4.89%	-14	-18	+47
USD Treasuries 10y	4.45%	-19	-47	+57
USD Treasuries 2s10s	-44.9bp	-5	-29	+11
GBP Gilt 10y	4.1%	-21	-55	+43
JPY JGB 10y	0.75%	-12	-4	-18
€ Sovereign Spreads (10y)	**20-Nov-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	56bp	-2	-6	+1
Italy	173bp	-12	-19	-41
Spain	99bp	-6	-8	-9
Inflation Break-evens (10y)	**20-Nov-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.33%	-5	-24	-22
USD 10y Inflation Swap	2.53%	-4	-13	+1
GBP 10y Inflation Swap	3.74%	-9	-18	-17
EUR Credit Indices	**20-Nov-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	149bp	-4	-11	-18
EUR Agencies OAS	73bp	+0	-6	-6
EUR Securitized - Covered OAS	81bp	+3	-6	-3
EUR Pan-European High Yield OAS	460bp	-6	-9	-52
EUR/USD CDS Indices 5y	**20-Nov-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	69bp	-5	-20	-21
iTraxx Crossover	385bp	-21	-84	-89
CDX IG	64bp	-3	-17	-18
CDX High Yield	415bp	-20	-107	-69
Emerging Markets	**20-Nov-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	426bp	-4	-16	-26
Currencies	**20-Nov-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.094	2.262	3.266	2.2
GBP/USD	$1.249	1.735	2.697	3.4
USD/JPY	JPY 148	2.327	1.072	-11.6
Commodity Futures	**20-Nov-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$81.2	-$1.3	-$9.7	0.0
Gold	$1 980.1	$33.2	-$1.3	8.6
Equity Market Indices	**20-Nov-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 514	2.24	6.86	17.6
EuroStoxx 50	4 337	2.48	7.77	14.3
CAC 40	7 250	2.30	6.37	12.0
Nikkei 225	33 388	2.46	6.81	28.0
Shanghai Composite	3 068	0.72	2.86	-0.7
VIX - Implied Volatility Index	14.19	-3.86	-34.64	-34.5

Source: Bloomberg, Ostrum AM

Additional notes

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