

International Commentary — September 28, 2022

Brazil to Complete Latin America's Second Pink Tide?

Summary

Latin America's return to the left-side of the political spectrum has been reminiscent of the original “pink tide” — the first time regional politics were dominated by left-leaning administrations in the 1990s and 2000s. But, the shift is not over yet as Brazil will host the first round of presidential elections this weekend, where former president Lula da Silva holds a wide lead over incumbent President Bolsonaro. Lula's rise concerned markets in 2002; however, his prior administrations, despite being highlighted by the initiation of social spending programs and wealth redistribution, were not especially radical and represented a fair degree of fiscal prudence. While Lula's party manifesto suggests a radical policy platform, we believe Lula will be more modest as he recently signaled technocratic policymakers will be part of his administration, and due to the fact Brazil's current public finance position requires tight fiscal policy.

In the event of a negative market reaction to a Lula victory, Brazilian real weakness should be faded. However, over the medium-term we believe the currency could weaken as external developments lead to U.S. dollar strength, and as Fed-Brazilian Central Bank monetary policy divergences build over time. We do not expect local political risk to be a source of Brazilian real depreciation, although we note that risks around our USD/BRL exchange rate forecasts are tilted toward a weaker Brazilian currency as country-risk premium could rise during Lula's third term. While not our base case scenario for the real, Lula still represents a potential risk to fiscal stability, and if credible fiscal policy evaporates, the Brazilian real could reach all-time lows against the U.S. dollar.

Economist(s)

Brendan McKenna

International Economist | Wells Fargo Economics
Brendan.Mckenna@wellsfargo.com | 212-214-5637

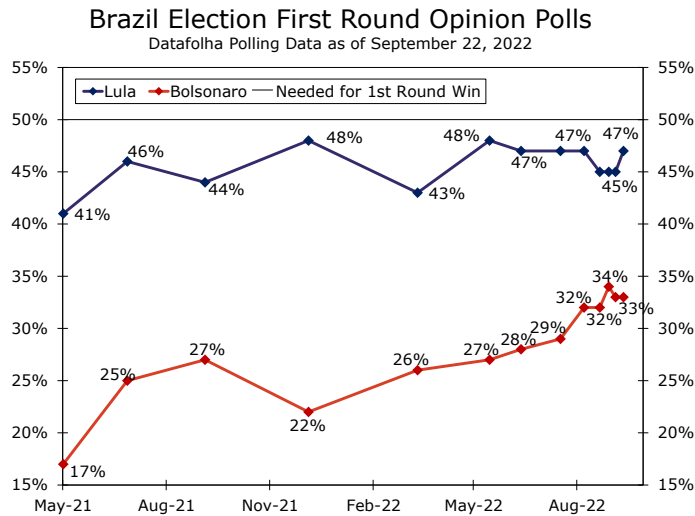
Let's Do The Time Warp Again!

For the last two years, we have written about and warned in regard to Latin America's shift to the left side of the political spectrum. In the aftermath of the pandemic, we believed populist-style politicians would gather a significant amount of momentum around the world. In our view, the economic backdrop was ripe for anti-establishment candidates to garner support as households suffered through a health crisis with unsatisfactory leadership, poor and worsening economic conditions, as well as loss of wealth and limited employment opportunities. These conditions yielded populist leaders around the world in the years following the Global Financial Crisis, and we believed the COVID crisis would ultimately deliver a similar political trend, particularly in Latin America as the region was arguably hit hardest during the pandemic. So far, this theme has materialized as populist-style politicians have been elected to office across the region. This was true in Peru, where the left-wing Pedro Castillo unexpectedly won the presidency on a platform of upending the country's economic model and implementing more radical policies to redistribute wealth. Similar dynamics unfolded in Chile, where the left-leaning Gabriel Boric won office on an unorthodox policy agenda centered around the government playing a larger role in the economy and widespread wealth redistribution. And most recently, in Colombia, Gustavo Petro swept to office on the most radical and left-leaning policy platforms the region has seen since the pandemic.

However, the wave of elections dominated by left-leaning Latin American politicians is not over yet. Next up is Brazil, where this weekend the country will host the first round of presidential elections. While multiple candidates will appear on the ballot this weekend, the two that have the greatest likelihood of success are current president Bolsonaro and former president Lula da Silva (Lula). For background, Bolsonaro won the 2018 election and is currently serving his first term in office. Early in his administration, Bolsonaro had success implementing initiatives that previous administrations tried, although failed, to accomplish. Those successes are highlighted by Bolsonaro facilitating changes to Brazil's constitution to reform the nation's pension system and realizing the privatization of many state-owned assets. On the other hand, Bolsonaro has come under just as much as scrutiny. For the last four years, allegations of corruption have been raised against Bolsonaro as well as members of the President's immediate family. In addition, Bolsonaro has taken a slightly more interventionist approach to policy outside his control, which resulted in sporadic bouts of financial market volatility over his administration. However, Bolsonaro has received the most criticism due to his perceived poor handling of the COVID pandemic as well as his push for deforestation of the Amazon in a world where ESG principles are paramount. Lula has had a more turbulent path back to politics. After two consecutive terms in office, from 2003-2010, and serving roles in successor administrations, Lula was charged with money laundering and corruption, and eventually spent close to two years in prison. However, in early 2021, Lula's convictions were annulled, and he was free to run for the presidency once again (Brazil only has a consecutive two-term limit, no total term limit). Despite his history, Lula is still wildly popular in Brazil. Under Lula, the Bolsa Familia cash transfer program was initiated, which took many households out of poverty, redistributed wealth across the nation, and made Lula one of the most popular politicians in the world. Despite new social spending programs, Lula also presided over an economy that boomed over the course of the commodity super-cycle and secured investment grade credit ratings on Brazil's sovereign debt.

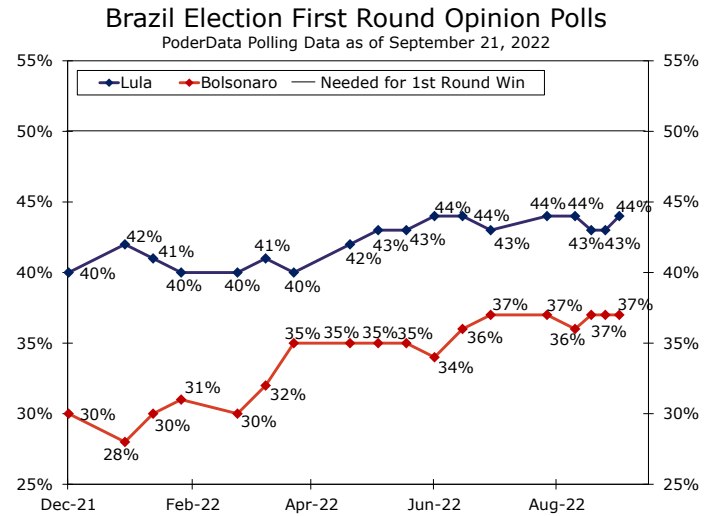
Lula's popularity is still apparent today. Since he became eligible to run for office, most opinion polls have suggested Lula is the front-runner to win this year's presidential election. Pollsters such as PoderData and Datafolha have indicated Lula has a wide lead over Bolsonaro since the middle of last year, and for the most part, that lead has never been in jeopardy. As of the latest polls, PoderData sees Lula winning 44% of first round votes and Bolsonaro receiving just 37% ([Figure 1](#)). Datafolha suggests Lula has a bigger lead, and that the former president could receive 47% of first round votes and Bolsonaro just 33% ([Figure 2](#)). Assuming polls accurately reflect voting intentions, the election will head to a runoff between Lula and Bolsonaro as no candidate will receive 50% of first round votes needed to be declared the winner after this weekend. In the event a runoff is indeed required, voters will return to voting stations on October 30 to choose between Lula or Bolsonaro. The same opinion polls suggest Lula has a more commanding lead in a runoff scenario against Bolsonaro. By most accounts, Lula is heavily favored to win back the presidency, and we would not completely dismiss the possibility that a runoff may not be needed as Lula could win the election outright after first round votes are tallied.

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2

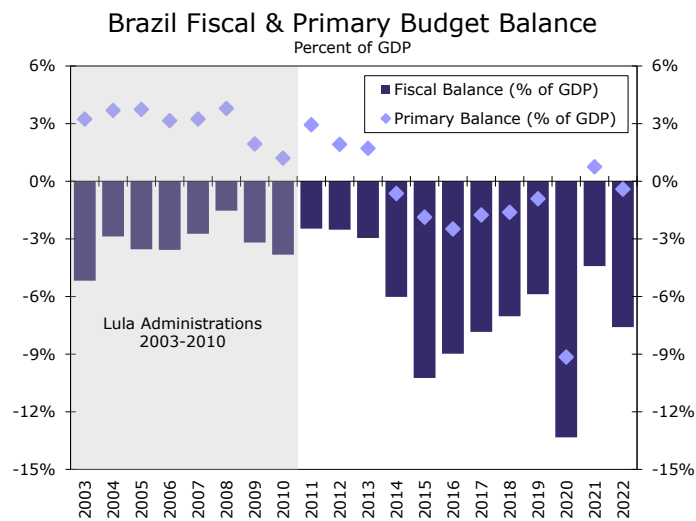


Source: Bloomberg Finance L.P. and Wells Fargo Economics

What Does Lula's Comeback Look Like?

Should Lula indeed win the presidency, we believe his third term would be cut from the same cloth as his prior administrations, and be only a small jump to the left. To that point, despite previous Lula campaigns being centered around an ultra left-leaning policy agenda, his prior administrations were not especially radical. Lula never pursued any expropriation of assets. He also respected the central bank's mandate to contain inflation and rarely inserted himself into Brazilian Central Bank (BCB) decisions, even though the BCB was not legally a fully independent institution during either of his administrations. Also, and of particular concern heading into the 2002 election, was the possibility of Lula placing Brazil's public finances on a significantly worsening trajectory. However, Lula maintained a primary balance surplus in every year of both administrations, even during the Global Financial Crisis (Figure 3). Perhaps a further step to the right, Lula's administrations exercised broader fiscal prudence. The Bolsa Familia social spending program were new expenditures; however, the overall fiscal balance remained in modest deficit of about 3% of GDP over the course of Lula's tenure. Arguably more impressive is that Brazil's debt burden steadily declined to 63% of GDP in 2010 from 78% when he was first elected in 2002 (Figure 4). While history is not an indicator of future behavior, Lula's past at least suggests fiscal discipline and a public finance profile that could improve over the course of a third administration.

Figure 3

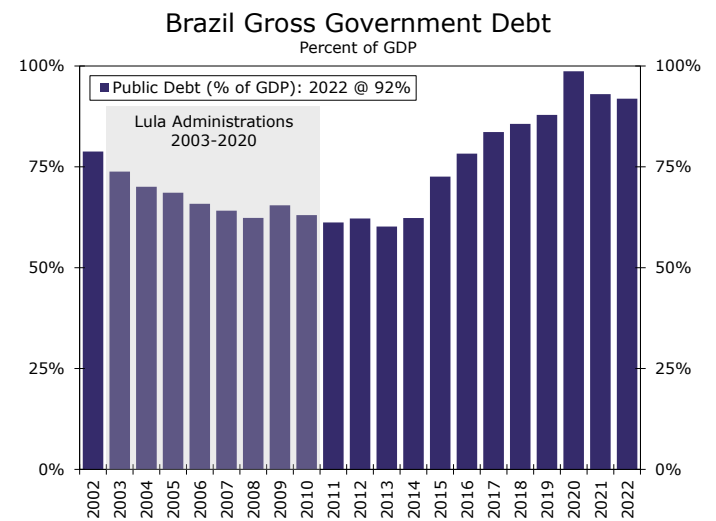


Source: International Monetary Fund and Wells Fargo Economics

However, there are a few key caveats we should note, as well as differences between today's local and global economic environment that should be highlighted. The first caveat being that the commodity super-cycle was just starting when Lula entered office in 2003. Oil, agriculture and precious metals prices embarked on a sharp and sustained rise over the course of most of Lula's administrations. This rise in commodity prices improved Brazil's terms of trade notably (Figure 5), and also became a source of new government revenues as well as growth for the local economy. Higher revenues and stronger GDP growth allowed the Lula administration to increase expenditures at a quicker pace without harming the overall budget balance. But, with the global economy on the brink of recession in 2023, we expect the recent downward movements in broad commodity prices to continue over the medium-to-longer term. As commodity prices decline, Brazil's economy should not only slow and enter a recession of its own, but the commodity revenues generated that supported prior Lula social spending programs will likely not be available. Without commodity driven revenues, Lula's plans to continue state-funded fiscal support could place government finances in a more precarious position than they already are. And certainly, Brazil's public finances are in much worse shape today than during the Lula administrations of the past. To that point, while the government will likely end this year with a balanced primary budget, the overall fiscal deficit is around 7.5% of GDP, about double the size of the budget deficit under Lula. In addition, Brazil's sovereign debt burden has risen to 92% of GDP, almost 30 percentage points higher than when Lula exited office.

Also in regard to public finances, Lula has commented multiple times on his preference to repeal the existing constitutional spending cap, a key pillar of Brazilian financial stability and an anchor of fiscal prudence. Lula has suggested he would replace the existing spending cap with a new fiscal regime, although underlying details of this new fiscal policy are vague and not fully available yet. Over the years, more so during the pandemic years, the credibility of Brazil's spending cap has diminished. Bolsonaro worked around constitutional spending limitations to funnel cash to vulnerable households most affected by COVID, while he also tweaked the interpretation of the cap to find new ways to distribute cash to less financially secure families. Should the existing spending cap be abandoned and not replaced by something *at least* as credible as the existing spending limitations policy, confidence toward the Lula administration's ability to implement a sound fiscal policy could evaporate. We should mention that Lula's prior administrations operated without a spending cap, as constitutional spending restrictions were introduced in 2016. But as mentioned, the constitutional spending cap is a bedrock of confidence towards Brazil, and should these spending limitations cease to exist or be disregarded completely, we would expect a significantly wider fiscal deficit as well as a sovereign debt trajectory that becomes more unsustainable as Lula pursues enhanced social spending programs. With that said, Lula has at least signaled moderation on the fiscal front by naming the center-right former Governor of São Paulo Geraldo Alckmin as his vice presidential candidate. In addition, Lula suggested Henrique Meirelles, a former central bank chief and finance minister known for his technocratic and pragmatic policies, could become a key part of Lula's cabinet. The combination of Alckmin and Meirelles, and hints toward a replacement spending cap, may buy Lula time with the international investment community;

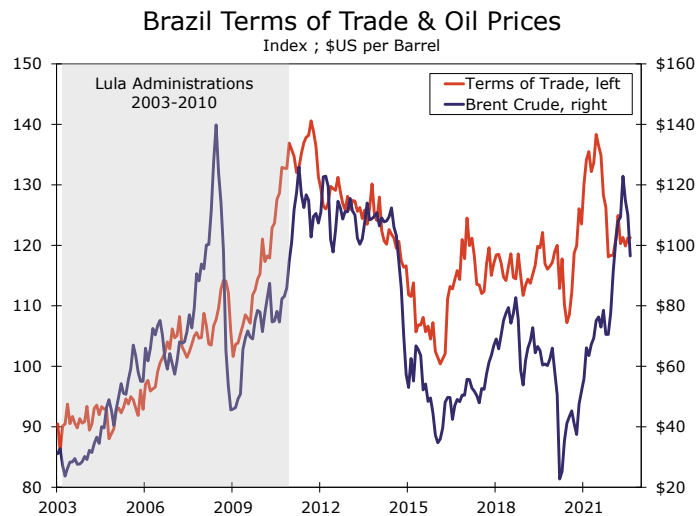
Figure 4



Source: International Monetary Fund and Wells Fargo Economics

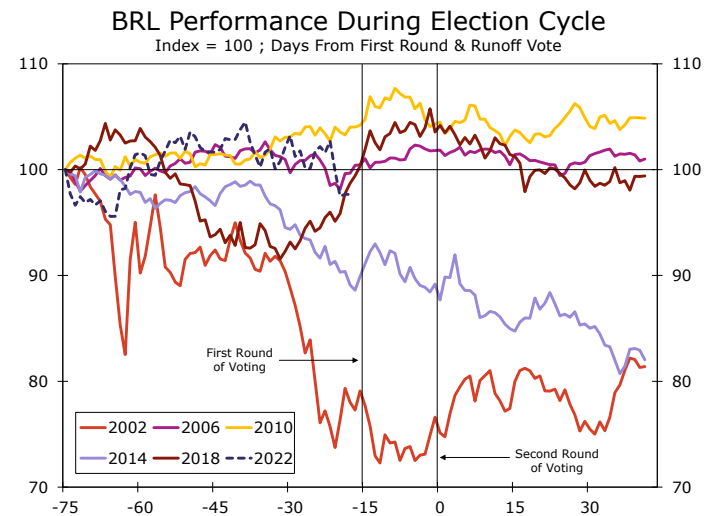
however, that leash could be short and any hints towards loose fiscal policy with no constraints would likely result in severe capital outflows, especially given the current state of Brazil's public finances.

Figure 5



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 6



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Real Love? Not Yet.

While we focused this report on the upcoming election, our base case view of the Brazilian real does not include political risk or election-related risks as a contributor to a weaker currency. As of now, political risk has not been a significant source of volatility or stress on the Brazilian currency, which is a bit surprising given how the currency performed during the 2002 election cycle when Lula was expected to win his first presidential term (Figure 6). While the currency has experienced some volatility headed into the election, we believe this volatility has been mostly driven by Fed hawkishness and deteriorating global growth prospects, and is not a product of political risk. We also believe there is a strong possibility that Lula is more moderate in his proposals than his party manifesto suggests. We believe Lula will respect the fact that Brazil's public finances are in poor shape, and a further deterioration in the fiscal balance and government debt could have negative repercussions on his administration's longevity as well as local financial markets. In our view, Lula bringing Alckmin and Meirelles on as cabinet members are a strong signal that Lula will indeed moderate his policy proposals, and even in the event he does turn slightly more unorthodox, a divided Brazilian congress should keep most of his unorthodox or potentially capital-outflow inducing proposals from being implemented. This scenario unfolded in 2002 as well, and the currency experienced a sharp rally after the second round of voting ended, with that rally continuing as Lula did not pursue his most extreme campaign proposals. In our view, any outsized negative reaction to a Lula victory, whether that victory comes in round one or in the runoff, should be faded. History suggests that most volatility comes in the lead up to the election, but in the short-term aftermath of a local presidential election, volatility declines and the currency stabilizes (2014 being the exception as the commodity super-cycle was in the process of imploding) (Also Figure 6). We believe this currency pattern, at least in the very near-term, will hold as markets digest the fact that Lula adopts a more moderate policy stance. These short-term political dynamics, however, will likely not be enough to prevent a medium-term BRL depreciation.

We have multiple concerns related to the medium-term path of the Brazilian real, and we forecast a weaker currency into early-to-mid 2023. Our primary concerns stem from developments outside of Brazil. External developments should keep depreciation pressure on the Brazilian currency into 2023, especially as the Fed leads the way in tightening monetary policy and global growth prospects dwindle amid recessionary conditions forming around the world. We believe a hawkish Federal Reserve will continue to result in broad U.S. dollar strength, and the Brazilian real can suffer as a result. Also, in the context of the Fed and monetary policy, we believe the Fed and the Brazilian Central Bank are about to enter a period of sustained divergence in their respective paths for monetary policy. Just recently, BCB policymakers opted to keep policy rates on hold and pause their tightening cycle, which

is a direction for local monetary policy that is at odds with the way interest rates are likely to evolve in the United States in the months ahead. As these interest rate differentials widen over time, we believe these dynamics can be the primary source of stress on the Brazilian real. And finally, our view for lower commodity prices going forward should also create downward pressure on the currency, and the full combination of broad U.S. dollar strength, diverging monetary policy paths, and lower commodity prices can push the USD/BRL exchange rate toward BRL5.80 by the middle of next year.

However, we do believe local politics represent a downside risk to the Brazilian real, and should political risk and country risk premium rise, the Brazilian currency could selloff more than we currently forecast. Downside risks stem from Lula potentially eliminating the constitutional spending cap, and not implementing new spending restrictions or a credible fiscal regime. In this scenario, we would expect market participants to exit Brazil, foreign direct investment to slow, and for the Brazilian currency to come under severe pressure. In a scenario where fiscal prudence is disregarded, we would expect the country-risk premium associated with Brazil to spike. We also wouldn't be surprised if credit rating agencies downgraded Brazil's sovereign rating as public finances deteriorate and the policy outlook turns more uncertain. Should this downside scenario materialize, we expect the USD/BRL exchange rate to breach all-time highs of BRL6.00.

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|----------------------|--------------------------|--------------|-------------------------------------|
| Jay H. Bryson, Ph.D. | Chief Economist | 704-410-3274 | Jay.Bryson@wellsfargo.com |
| Sam Bullard | Senior Economist | 704-410-3280 | Sam.Bullard@wellsfargo.com |
| Nick Bennenbroek | International Economist | 212-214-5636 | Nicholas.Bennenbroek@wellsfargo.com |
| Tim Quinlan | Senior Economist | 704-410-3283 | Tim.Quinlan@wellsfargo.com |
| Sarah House | Senior Economist | 704-410-3282 | Sarah.House@wellsfargo.com |
| Azhar Iqbal | Econometrician | 212-214-2029 | Azhar.Iqbal@wellsfargo.com |
| Charlie Dougherty | Economist | 212-214-8984 | Charles.Dougherty@wellsfargo.com |
| Michael Pugliese | Economist | 212-214-5058 | Michael.D.Pugliese@wellsfargo.com |
| Brendan McKenna | International Economist | 212-214-5637 | Brendan.Mckenna@wellsfargo.com |
| Shannon Seery | Economist | 332-204-0693 | Shannon.Seery@wellsfargo.com |
| Nicole Cervi | Economic Analyst | 704-410-3059 | Nicole.Cervi@wellsfargo.com |
| Jessica Guo | Economic Analyst | 212-214-1063 | Jessica.Guo@wellsfargo.com |
| Karl Vesely | Economic Analyst | 704-410-2911 | Karl.Vesely@wellsfargo.com |
| Patrick Barley | Economic Analyst | 704-410-1232 | Patrick.Barley@wellsfargo.com |
| Jeremiah Kohl | Economic Analyst | 704-410-1437 | Jeremiah.J.Kohl@wellsfargo.com |
| Coren Burton | Administrative Assistant | 704-410-6010 | Coren.Burton@wellsfargo.com |

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