ECONOMICS

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Brazil – Risk Premium

Apples and Oranges

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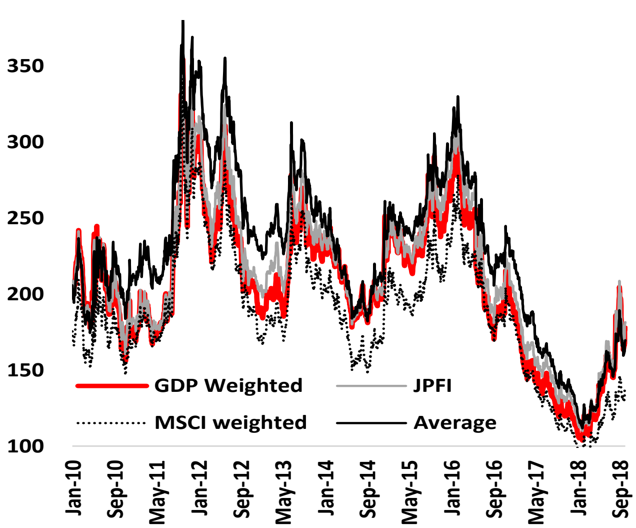
"EM and Brazilian Risk Premiums Are Like Apples and Oranges. They Both Are Fruit, But Taste Different" (Stephen King, modified)

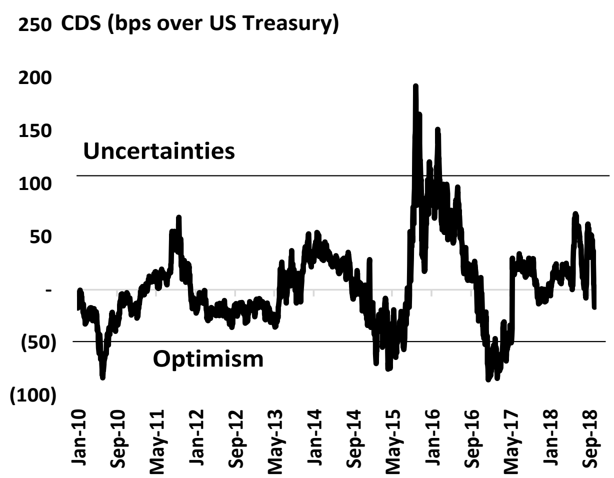
- **In this report, we are updating our preferred measure of high-yield and EM-sovereign risk aversion, comprised of the 5-year CDS of 24 economies.**
- **We have concluded that global risk premiums have been on the rise since the beginning of the year. This trend is not unique to Brazil or any specific region, but rather is likely associated with an ongoing process of monetary policy inflection in developed economies, as well as less benign growth.**
- **We decompose the dynamics of Brazilian CDS by a common/external factor (overall risk aversion, commodity prices and global interest rates) and an idiosyncratic component, which is related only to the unique characteristics of the country (notably, the market's assessment of the expected evolution of fundamentals).**
- **The market already seems to be pricing in a favorable outcome for elections, meaning a higher probability of the next president credibly signaling the willingness and ability to pursue a reasonable fiscal agenda and social security reform.**
- **Our year-end 2018 forecast for the BRL (3.80 to the USD) implies that Brazil will likely restore its fiscal credibility, which would lead to further compression of the idiosyncratic component of the risk; however: (i) there is still significant uncertainty regarding fiscal execution and (ii) overall risk aversion should likely resume its previous trend toward the average of the last 10 years.**
- **In any case, at this point we recognize that the risks to our scenario are biased toward the optimistic side for year-end 2018 (downside to risk premiums and upside to the BRL).**

Figure 1. High-Yield and EM-Sovereign Risk Premiums (Selected Countries, bps)



Source: Santander estimates based on Bloomberg data.

Figure 2. Idiosyncratic Component of Brazil Risk



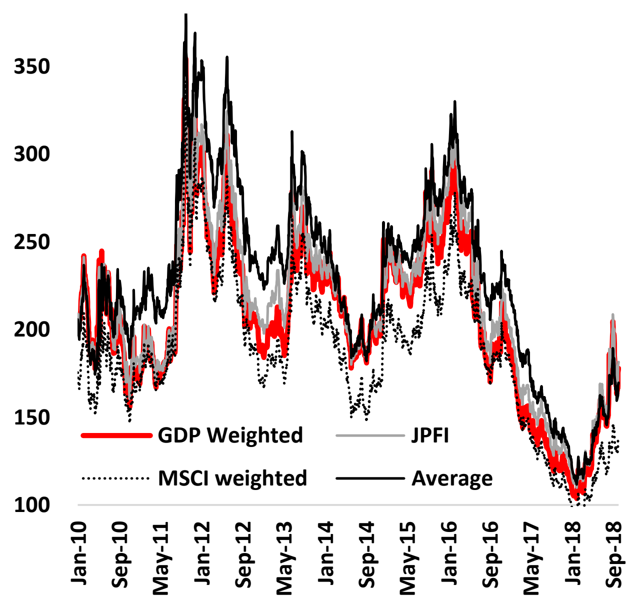
Source: Santander estimates based on Bloomberg data.

High-Yield and EM-Sovereign Risk Premium Sample

In this report, we are updating our preferred measure of high-yield and EM-sovereign risk aversion, comprised of the 5-year CDS of 24 economies: Argentina, Chile, Colombia, Mexico, Panama, Peru, Croatia, Greece, Hungary, Poland, Romania, Russia, Turkey, China, India, Indonesia, Malaysia, Philippines, Thailand, Vietnam, Egypt, Morocco, Nigeria and South Africa.

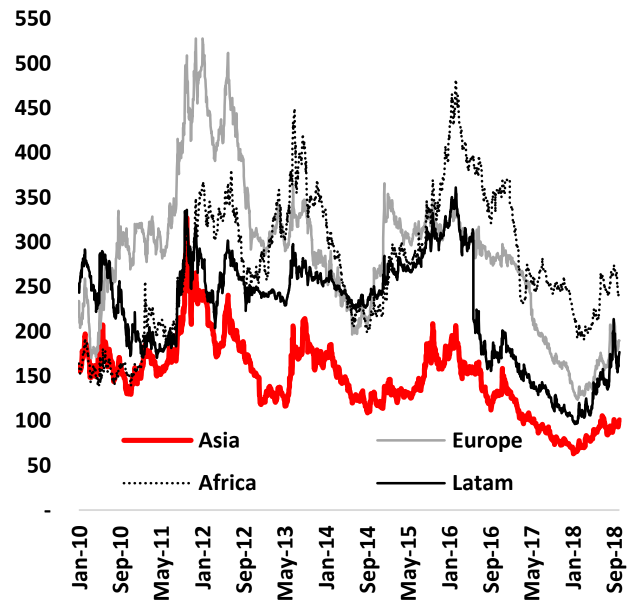
Figure 3 illustrates four different ways of aggregating this measure: (i) a simple average, (ii) weighted by GDP, (iii) weighted by the J.P. Morgan EM Bond ETF index and (iv) weighted by the MSCI index. Figure 4 shows a sample of sovereign CDS by region.

Figure 3. High-Yield and EM-Sovereign Risk Premiums (Selected Countries, bps)



Source: Santander estimates based on Bloomberg data.

Figure 4. High-Yield and EM-Sovereign Risk Premiums (Selected Countries, bps), by Continent



Source: Santander estimates based on Bloomberg data.

So What?

In our view, a lot can be learned from the charts above.

Long-term trends:

1) There has been a prolonged period of improvement in international market conditions, particularly during 2016 and 2017 (coincidently, the period just after the political inflection in Brazil).
2) This favorable performance has likely been driven by still-comfortable conditions in terms of global liquidity, coupled with recovering growth in developed economies.
3) Global risk aversion to sovereign EM (at least based on our sample) seems to be close but not back to the average of the last 10 years.

Short-term:

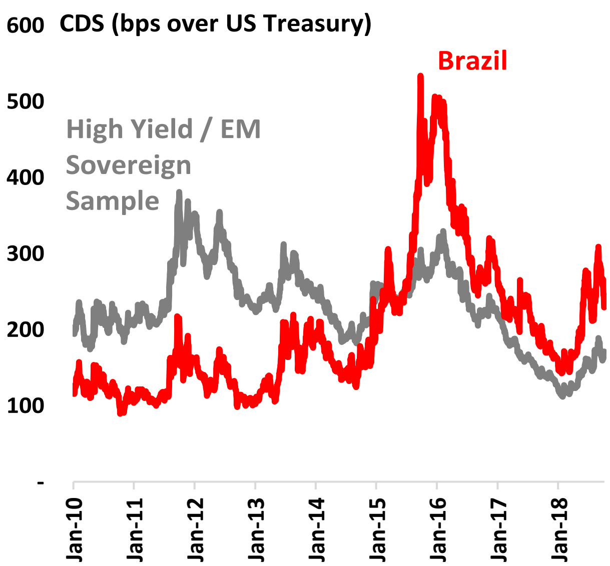
4) Risk premiums have been on the rise since the beginning of the year. This trend is not unique to Brazil (where it may be associated with elections) or any specific region, but rather is likely associated with an ongoing process of monetary policy inflection in developed economies, as well as less benign growth.
5) Therefore, in spite of the improvement in CDS spreads that we have witnessed in recent days and weeks, the medium-term trend is likely a convergence to the average (higher risk premiums) as long as the Fed and other important central banks continue to pursue normalization of monetary policy.

What About Brazil?

As you may have already noticed, our county sample does not include Brazil. This is because we intend to decompose the dynamics of Brazilian CDS by a common/external factor (overall risk aversion, commodity prices and global interest rates) and an idiosyncratic component that is related only to the unique characteristics of the country (notably, the market's assessment of the expected evolution of fundamentals). Therefore, it is important that our measure of common risk aversion is minimally affected by what is happening in Brazil (although we recognize that in spite of having a broad sample, Brazil ends up exerting some influence on overall sovereign risk aversion).

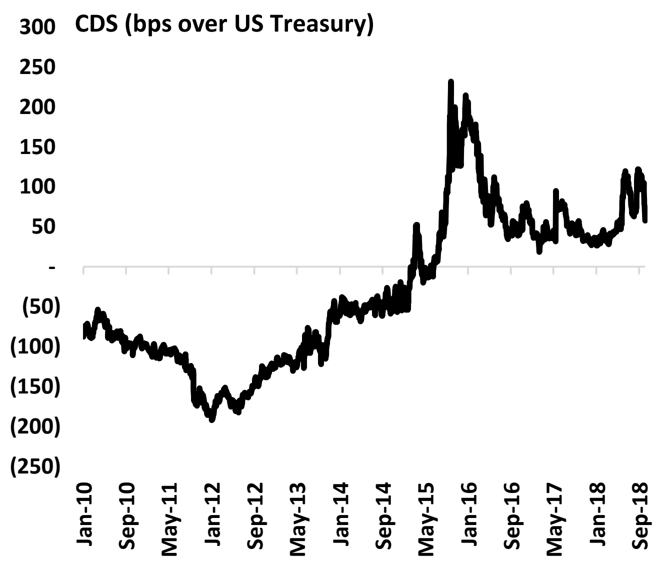
Figure 5 shows how the Brazilian risk premium (as proxied by its own 5-year CDS) has evolved vis-a-vis our EM high-yield sovereign sample (simple average). Figure 6 shows the difference between those two measures.

Figure 5. High-Yield and EM-Sovereign Risk Premiums (Selected Countries, bps) vis-a-vis Brazil CDS



Sources: Santander estimates based on Bloomberg data.

Figure 6. Difference Between Brazil CDS and a High-Yield and EM-Sovereign Risk Premiums (Selected Countries, bps)



Sources: Santander estimates based on Bloomberg data.

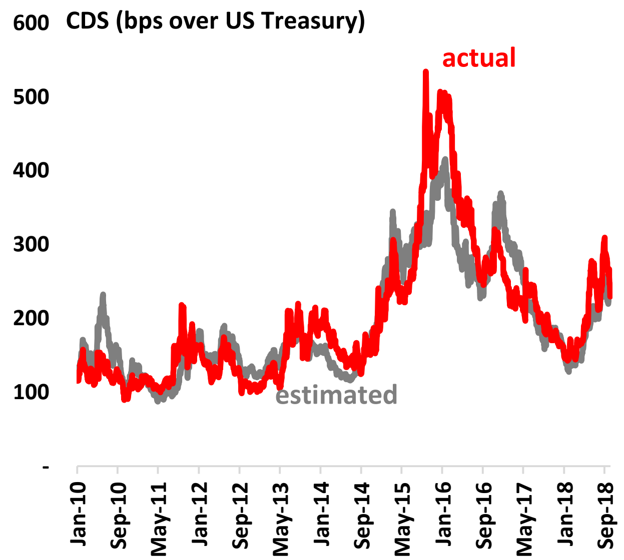
We still do not consider the simple difference between the Brazil CDS and our measure of EM/high-yield sovereign risk aversion as the most appropriate indicator for the assessment of the idiosyncratic component of Brazilian risk, because: (i) there are important external variables which affect Brazil and overall risk aversion in different ways, such as commodities and global interest rates, and (ii) the sensitivity of Brazilian CDS against the sample is not expected to be a 1-to-1 relationship.

We see reasons to believe that Brazil is a high-beta country, meaning that a change in overall risk aversion generates a more pronounced change in the perception of Brazilian risk. This high-beta component is likely associated with: (i) the importance and liquidity of Brazilian assets in international markets (due to the size and development of Brazilian financial markets) and (ii) the fact that the economy is still very closed to international trade (low exports and imports as a percentage of GDP), meaning that financial FX flows (which tend to be more volatile) are much larger than trade flows (which tend to be more stable).

The Idiosyncratic Component of Country Risk

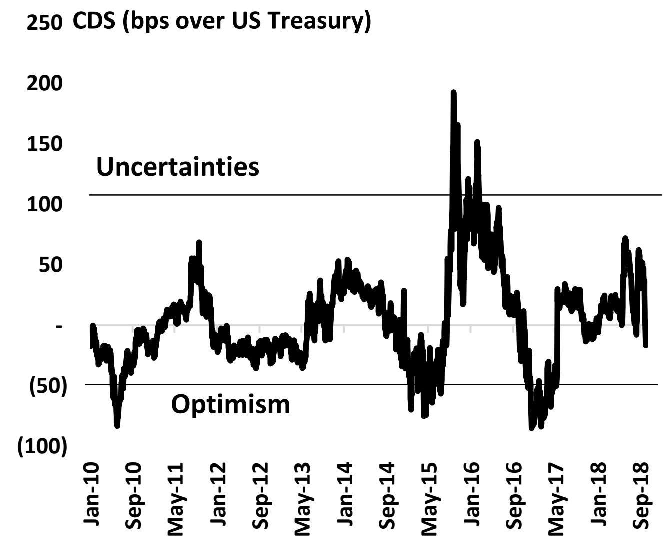
In order to identify the "pure" idiosyncratic component, we ran regressions to estimate the coefficients of external variables and overall risk aversion for the Brazil CDS. We consider the residual of this regression as a better proxy for the unique component of the Brazilian risk premium. The following charts illustrate the outcome of our preferred model. Figure 7 shows the actual Brazilian CDS and its estimates based on external variables (overall risk aversion, commodities and 10-year Treasury yields). Figure 8 illustrates the idiosyncratic component of Brazilian country risk.

Figure 7. Brazil CDS (estimated and actual)



Source: Bloomberg and Santander estimates.

Figure 8. Idiosyncratic Component of Brazil Risk



Sources: Bloomberg and Santander estimates.

So, What Are You Saying?

What we are saying here is that the market already seems to be pricing in a favorable outcome for the elections, meaning a higher probability of the next president credibly signaling the willingness and ability to pursue a reasonable fiscal agenda and social security reform.

The idiosyncratic component of risk premium is currently at -16, compared to an average in the last 10 years of +3. This current level is much smaller than during the country's worst moments (around 100) and its best (around -50). If you consider a binary scenario of (i) restoring fiscal credibility (optimism) and (ii) prevailing uncertainties, a back-of-the-envelope estimate would suggest that markets are assigning a 70% probability to a benign outcome.

In this sense, it is important to emphasize that, although asset prices are probably reflecting the likelihood of a favorable scenario, there is room – at least in the short term – for further improvement in terms of the idiosyncratic component of country risk, should expectations regarding reform converge back to that which prevailed in the first half of 2017.

Another important conclusion from our model is that the elasticity of Brazilian CDS to sovereign risk aversion is very close to 2. This means a 10-bps variation in the average of emerging-market and high-yield CDS usually leads to a variation of 20 bps for the Brazilian CDS, confirming our hypothesis of a high-beta variable.

What If?

Therefore, if the new president is able to restore credibility on the fiscal reform, we see room for country risk to fall further from 230 bps to 150-170 bps. This would likely be associated with an exchange rate stronger than BRL 3.50 / USD. On the other hand, increased uncertainty could drive the Brazilian CDS above 300 bps, which means an exchange rate likely weaker than BRL 4.30 / USD.

Our year-end 2018 forecast for the BRL at 3.80 / USD implies that Brazil will likely restore its fiscal credibility, which would lead to further compression of idiosyncratic risk; however: (i) significant uncertainties regarding execution remain and (ii) overall risk aversion should resume its previous trend toward the average of the last 10 years (preventing Brazilian CDS and other assets from improving toward the optimistic scenario).

In any case, at this point we recognize that the risks for our scenario are biased to the optimistic side (downside to our year-end 2018 forecasts for the Brazilian risk premium and upside to the exchange rate).

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