Santander

# ECONOMICS

January 31, 2019

## Brazil – Risk Premium

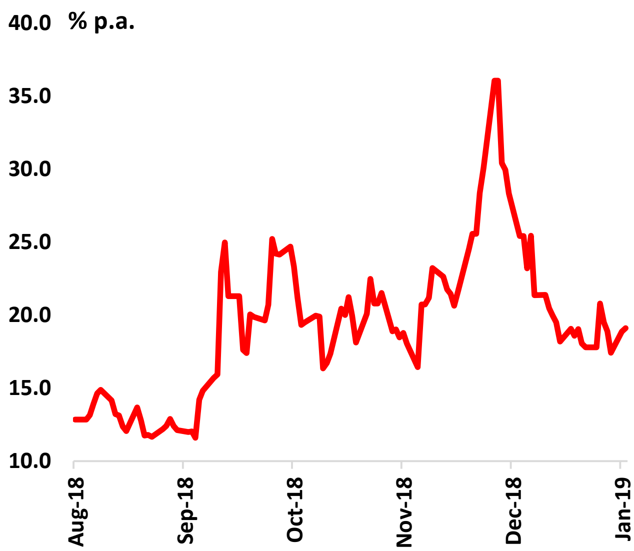
### Brazilian Asset Prices: How Much "Over" Has the Performance Been?

**Maurício Molan***
mmolan@santander.com.br
+55-11-3553-5263

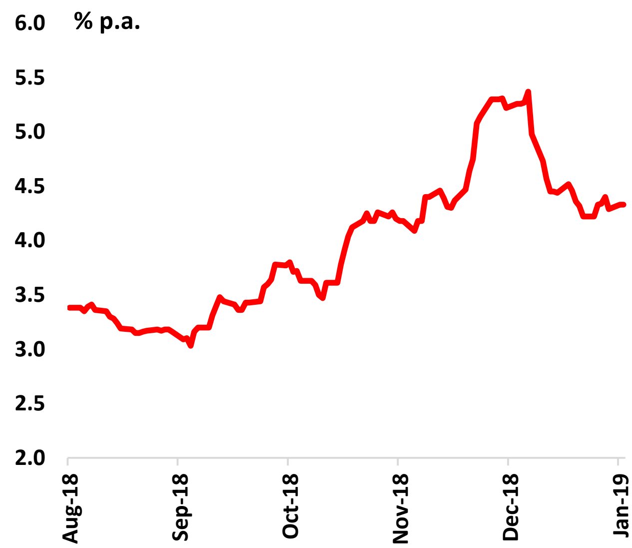
- **The performance of Brazilian asset prices so far in 2019 has been exceptional.**
- **But, although the importance of external factors to the dynamic of Brazilian assets is well known, it is often forgotten.**
- **We conclude that most, if not all, of the improvement in Brazilian assets in January could be related to external factors rather than factors specific to Brazil.**
- **This could represent both a problem and an opportunity, in our view.**
- **We see a potential opportunity because there could be room for additional improvement if the country delivers on pension reform, privatizations, and a short-term fiscal adjustment.**
- **The danger, in our view, is if Brazil does not take advantage of the positive global environment to do the fiscal adjustment in order to be better prepared for a rainy day.**
- **As history shows, the favorable view of international investors toward Brazil will not last forever.**

**Global Risk Aversion**

**VIX**




**High Yield**




Source: Bloomberg.

## Introduction

The performance of Brazilian asset prices so far in 2019 has been exceptional. The Ibovespa gained around 12% in local currency, 10-year yields shrank by 37 bps, and the currency strengthened 6% against the USD. All of this was sustained by an improved risk assessment, reflected in the CDS measure, which contracted to 163 bps (for five-year contracts) from 206 bps.

We acknowledge that there are reasons be optimistic. Consumer confidence is improving (suggesting that an acceleration of economic growth is around the corner), inflation is surprising to the downside (increasing the likelihood that the Selic rate will stay lower for longer), and investors are assigning a high probability that an adequate pension reform will be approved by the legislature and the executive in 2019.

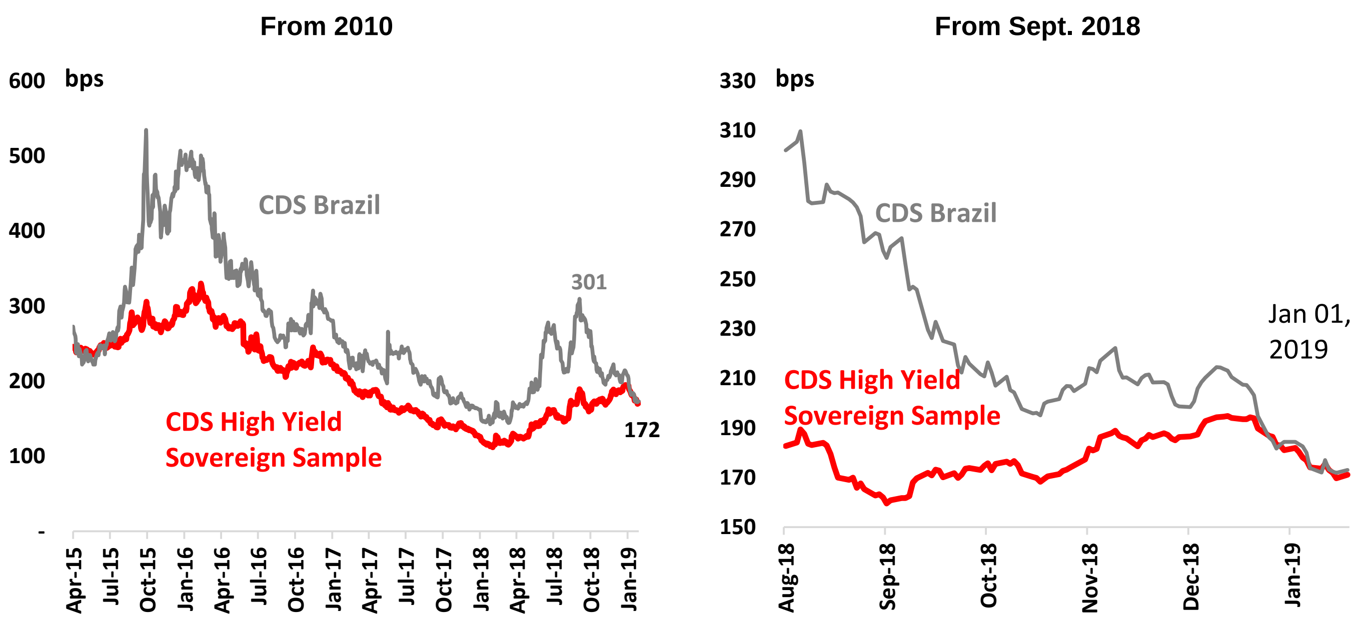
**Nevertheless, a more holistic assessment of global financial indicators suggests that most, if not all, of the improvement described above is related to external factors. After all, global risk eased substantially at the beginning of this year, which contributed to add value to a great number of assets, particularly in emerging markets.**

## Common Factors and the Idiosyncratic Component of the CDS

In this report, we are updating our preferred measure of high-yield and EM-sovereign risk aversion, comprised of the five-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 (see our report *Risk Premium: Apples and Oranges*, October 9, 2018).

The following charts illustrate the dynamics of the last decade as well as what has occurred since September 2018. It seems clear that, after a substantial improvement on the eve of the presidential elections, the Brazilian risk premium began to evolve to more closely approach that of our sample of high-yield countries. By our calculations, the correlation increased significantly in January.

**CDS Brazil and High Yield Sovereign Sample (bps)**




Sources: Santander estimates based on Bloomberg data.

This similar dynamic for the Brazilian risk premium and that of our high-yield sample suggests that there may have been a common factor driving down the spreads of Brazil and other emerging economies, most likely global risk aversion, in our view. The charts on page 1 illustrate what has happened to two well-known measures of financial markets' risk aversion in the last five months: (i) the VIX, which represents the markets' expectation of 30-day forward-looking volatility, derived from the price inputs of the S&P 500 index options, and (ii) the average yield of risky bonds (high-yield index).

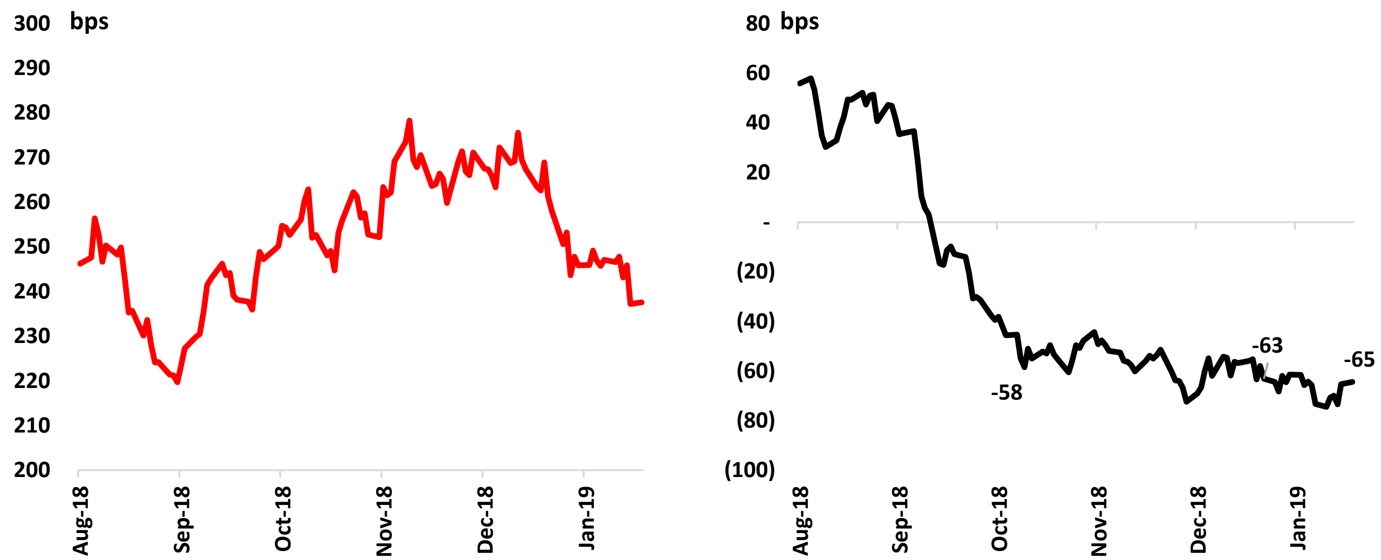
It is not a coincidence, in our view, that all indicators shown in this report have shown substantial improvement in January, after marked deterioration through the end of last year. In our view, concerns that monetary policy in the US could turn excessively tight while China could experience a steeper and more rapid slowdown explains the negative market assessment that intensified in November. Among other explanations, the reaction in January could be associated with both liquidity injections in China and with a more dovish message from the US Fed. Not surprisingly, in our view, commodities prices (including crude) interrupted the downward trend, and the US dollar lost value not only against emerging currencies but also against those of developing countries.

## What About the Idiosyncratic Factor?

In order to identify the “pure” idiosyncratic component of Brazilian CDS, we ran regressions to estimate the coefficients of external variables and overall risk aversion to the Brazil CDS (again, see our report *Apples and Oranges*, cited previously). We consider the residual of this regression as a better proxy for the unique component of the Brazilian risk premium. The following charts illustrate what has happened recently with the common component and the residual.

**The Common and the Idiosyncratic Components**

**External Factors (global risk aversion, commodities, US interest rates)** — **Idiosyncratic Component**




Source: Bloomberg.

These two figures clearly illustrate the important role external factors have played in the improvement of Brazilian risk assessment that we have seen in January. After posting substantial gains on the eve of the presidential elections, the components of the CDS not explained by external factors have declined only marginally.

## Conclusion

**The importance of external factors to the dynamic of Brazilian assets is well known but often forgotten. It is quite common to see the BRL underperforming other EM currencies during cycles of overall appreciation of the US dollar, and outperforming when the greenback loses value. We say the currency has a high beta relative to other developing economies.**

**By the same token, a favorable evolution of the external environment tends to generate a stronger improvement of Brazilian CDS than that of most other economies. According to our estimates, each 1 p.p. variation in our high-yield sovereign sample tends to move Brazilian CDS by 2 p.p. in the same direction.**

**We conclude that most, if not all, of the improvement in Brazilian assets in January could be related to external factors rather than to factors specific to Brazil (the latter possibly associated with a better outlook for fiscal accounts). This could present both a problem and an opportunity, in our view. We see a potential opportunity because there could be room for additional improvement if the country delivers on pension reform, privatizations, and a short-term fiscal adjustment. The danger, in our view, is if Brazil does not take advantage of the positive global environment to do the fiscal adjustment in order to be better prepared for a rainy day. As history shows, the favorable view of international investors toward Brazil will not last forever.**

## CONTACTS / IMPORTANT DISCLOSURES


| Macro Research | | | |
|---|---|---|---|
| Maciej Reluga* | Head Macro, Rates & FX Strategy – CEE | maciej.reluga@santander.pl | 48-22-534-1888 |
| Sergio Galván* | Economist – Argentina | sgalvan@santanderrio.com.ar | 54-11-4341-1728 |
| Maurício Molan* | Economist – Brazil | mmolan@santander.com.br | 5511-3012-5724 |
| Juan Pablo Cabrera* | Economist – Chile | jcabrera@santander.cl | 562-2320-3778 |
| Diana Ayala | Economist – Colombia, Peru | diana.ayala@santander.us | 212-407-0979 |
| Guillermo Aboumrad* | Economist – Mexico | gjaboumrad@santander.com.mx | 5255-5257-8170 |
| Piotr Bielski* | Economist – Poland | piotr.bielski@santander.pl | 48-22-534-1888 |
| Marcela Bensión* | Economist – Uruguay | mbension@santander.com.uy | 5982-1747-5537 |
| **Fixed Income Research** | | | |
| Diana Ayala | Macro, Rates & FX Strategy – Latin America | diana.ayala@santander.us | 212-407-0979 |
| Juan Arranz* | Chief Rates & FX Strategist – Argentina | jarranz@santanderrio.com.ar | 5411-4341-1065 |
| Juan Pablo Cabrera* | Chief Rates & FX Strategist – Chile | jcabrera@santander.cl | 562-2320-3778 |
| David Franco* | Macro, Rates & FX Strategy – Latin America | david.franco@santanderCIB.co.uk | 44-207-756-6633 |
| Aaron Holsberg | Head of Credit Research | aholsberg@santander.us | 212-407-0978 |
| **Equity Research** | | | |
| Christian Audi | Head LatAm Equity Research | caudi@santander.us | 212-350-3991 |
| Andres Soto | Head, Andean | asoto@santander.us | 212-407-0976 |
| Walter Chiarvesio* | Head, Argentina | wchiarvesio@santanderrio.com.ar | 5411-4341-1564 |
| Nicolas Schild* | Head, Chile | nschild@santander.cl | 5622-336-3361 |
| Valder Nogueira* | Head, Brazil | jvalder@santander.com.br | 5511-3012-5747 |
| Cecilia Jimenez* | Head, Mexico | mcjimenez@santander.com.mx | 5255-5269-2228 |


| Electronic Media | |
|---|---|
| Bloomberg | SIEQ <GO> |
| Reuters | Pages SISEMA through SISEMZ |

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Mauricio Molan*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.



Santander
Corporate & Investment Banking