# What Will Brazil Look Like Under Lula?

November 2022

**Dear investors,**

The contest between Bolsonaro and Lula left the country extremely polarized, with campaigns characterized by much sensationalist rhetoric and few concrete policy proposals. Now that the heat of battle has passed, the question that matters is: with Lula elected, what does the future hold for Brazil?

When evaluating a company, understanding its business model, market positioning, and historical track record are more critical steps than assessing who the CEO is. Similarly, Brazil's future depends far more on where the country stands today, the starting point for Lula's government, and the environment he is likely to face over the course of his term. We will therefore focus more on the country that will be governed than on its future governor.

We will discuss how Brazil may be affected by three major themes that are prominent in the global macroeconomic landscape: i) widespread inflation, a side effect of policies adopted during the pandemic that was amplified by the surge in commodity prices; ii) the geopolitical crisis caused by the Russia-Ukraine war; and iii) the energy crisis triggered by the embargoes imposed in the context of the war and by the decarbonization of energy matrices.

## Global Inflation

The entire world is grappling with inflation right now because every country was hit by the pandemic, and most of them adopted very similar courses of action. The main measures are well known: lockdowns and emergency relief programs. Both contributed to creating the inflation that is now being fought.

The contribution of the lockdown came through the disruption of production chains, which reduced the supply of many goods and thereby fueled price increases. With the reopening and reorganization of economies which occurred some time ago, this factor has been largely overcome and is no longer a central driver of inflation.

The second factor is harder to reverse. Emergency relief programs (using the Brazilian term to refer also to equivalent programs implemented by governments around the world) were largely financed through monetary base expansion, i.e., governments printing money. This reduces the value of money and therefore causes widespread price increases (inflation). This effect is inevitable, since the creation of new money is not accompanied by the creation of real economic value. In a simplified example: if every government in the world doubled the amount of currency in circulation, everything would cost twice as much, since there would be twice as much money to represent the same existing stock of goods. Central bank maneuvers clearly do not have the power to make the world richer.

In practice, by printing money and distributing it in the form of emergency relief, governments expropriated capital from all those invested in assets not indexed to price levels (primarily fixed income securities) and redistributed it to the most economically vulnerable populations, quite rightly, in our view, since those populations were prevented by the government itself from working for their own livelihood during the lockdowns. There is a subtlety to this arrangement:

the loss of monetary value is not immediate. It arrives as a wave of inflation that erodes the value of money over time. That is what the world is experiencing today.

## High interest rates: the bitter medicine

To combat inflation, central banks around the world resorted to the classic measure of raising interest rates. The logic of this action is that higher rates reduce economic activity by curtailing the availability of credit for consumption and new investment. As a result, overall demand for goods and services is reduced and prices tend to fall.

The problem is that high interest rates are like the fever our immune system generates to fight a virus. They solve the problem, but only after keeping us bedridden for several days. Controlling inflation will require maintaining elevated rates for several more months, and over that period economic growth is significantly impaired. This is the source of the global recession risk that has been widely discussed.

Inflation and high interest rates are well-known territory in Brazil. Given our economic history, the Central Bank of Brazil has considerable experience dealing with inflation and moved swiftly. It raised Brazil's interest rates approximately one year before the central banks of developed countries were convinced that such a measure was actually necessary, and it acted more aggressively as well. While the Federal Reserve raised the U.S. rate from 0.25% per year in March 2022 to 3.25% currently, Brazil moved from 2.00% in March 2021 to the current 13.75%.

Today Brazil is, in market parlance, "ahead of the curve." Having begun its fight against inflation earlier and more vigorously, we are far closer to bringing inflation under control than the United States or Europe. The market anticipates that interest rate cuts and the convergence of inflation toward normal levels (around 5%) will already begin in 2023.

Even with inflation under control sooner, Brazil will still feel the impact of the global economic slowdown, but we have two mitigating factors. The first is that Brazil has a less globalized economy than the United States or Europe. Our foreign trade flow represented 39% of 2021 GDP, compared to a global average of 52% in 2020. This is not entirely a good thing, since Brazil could have grown more in the past had it opened its markets further. But in this moment of global crisis, our economy is less exposed and should be less severely affected. The second mitigating factor relates to the geopolitical crisis, which we will discuss next.

## The new Cold War

The war between Ukraine and Russia began in February 2022, eight months ago. The military conflict has been confined to Ukrainian territory, but the effects of the war have reached far beyond its borders. The West adopted the strategy of not intervening militarily with NATO forces which would carry a considerable risk of triggering a new world war, but positioned itself alongside Ukraine by supplying weapons, financing its war costs, and imposing economic sanctions on Russia.

Russia responded to the sanctions by restricting its supply of commodities, particularly oil and natural gas, to the countries supporting Ukraine. The main impact of this action is the current energy crisis in Europe, which had been dependent on Russian natural gas to power its heating systems and electricity generation. We will return to this topic shortly, but first let us explore a broader geopolitical trend that the war has intensified.

Until a few years ago, the world was following a trend toward economic globalization. Increasingly integrated supply and production chains were being built, pursuing David

Ricardo's ideal of leveraging each country's cost advantages to achieve maximum economic efficiency. This movement began to reverse with the trade frictions between China and the United States under Donald Trump. Now, the war in Ukraine appears to have convinced much of the rest of the world that globalization went too far and that it is time to take some steps back.

The war made the risks of deeply integrated economies more tangible and visible for everyone. Angela Merkel's Germany had made its energy matrix heavily dependent on Russia, which supplied approximately 55% of Germany's imported natural gas and 35% of its imported oil. The decision was not economically irrational: Russia offered competitive prices and sufficient capacity to sustain supply for a long time. But Germany is now paying a heavy price for having ignored the political dimension of the arrangement placing a significant portion of its country's energy supply under the pen of Vladimir Putin. Interestingly, this risk was flagged by Donald Trump at a NATO conference in 2018. German politicians dismissed it as unjustified extremism and set the matter aside.

There are other significant risks of the same nature that have not yet become problems. For example, Taiwan today produces more than 90% of the world's high-technology processors (below 10 nm) and between 30% and 50% of processors in other categories. This largely explains the political tensions surrounding Taiwan and China, with the United States intervening to keep Taiwan an independent territory.

## Brazil in a deglobalizing world

With the world increasingly attentive to the risks of dependence on other countries for the supply of commodities and critical products, we expect to see over the coming years a movement toward decentralizing production chains and reducing trade ties with politically misaligned countries. This shift is not simple and may take decades, but it is a trend that could have enormous economic consequences.

The logic behind decentralizing production chains is well known in the business world. Deep dependence on a single supplier is inadvisable, as it excessively reduces bargaining power and exposes a business to the risks of sudden price spikes or supply disruptions.

Companies exercise this caution even when they can establish long-term contracts and resort to courts to enforce them. Countries have no global tribunal to which they can appeal to ensure the fulfillment of agreements, so there should be an additional concern about selecting as partners those countries with a low probability of becoming politically hostile as Russia has become for the West.

In practical terms, the expectation is that portions of the production chains currently dependent on China will be transferred to countries that are geographically closer and more politically aligned with the United States and Western Europe. This trend has been called friendly-shoring, by analogy with the offshoring policy that made China what it is today.

The current scenario presents a unique opportunity for Brazil, a country with the world's sixth-largest population, low-cost labor, an extensive territory, and abundant natural resources. In addition, Brazil is geographically close to the United States and Western Europe and is strongly aligned with Western geopolitical values. We are therefore strong candidates to capture a portion of the demand currently served by China, which could bring a wave of foreign investment and drive our economic development.

## The energy crisis

Let us return to the subject of Europe's natural gas shortage. The story began with the plan to decarbonize the economy in order to combat global warming. This topic has blended scientific and political agendas, but in a greatly simplified way, the relationship between $CO_2$ concentration in the atmosphere and the rise in average global temperature has been understood for more than a century. An article published in 1896 by Svante Arrhenius, winner of the Nobel Prize in Chemistry in 1903, estimated the relationship between increases in $CO_2$ concentration and atmospheric temperature with reasonable precision. Despite this, it was only in recent decades that coordinated action by multiple countries was organized to address the problem, with the principal measure being a reduction in the $CO_2$ emissions generated by economic activity.

In this context, reducing $CO_2$ emissions in electricity generation was one of the central planned measures. Europe began decommissioning its coal- and oil-fired thermal power plants and replacing them with natural gas plants, which emit approximately 50% less $CO_2$ than coal and 40% less than oil for the same amount of electricity generated (emissions vary considerably depending on the efficiency of each plant). Germany was among the countries that pushed hardest in this direction, which is why it is now suffering severely from cuts in Russian natural gas supplies.

Despite the problems with Russia, the major Western economies are expected to continue their decarbonization drive, with the goal of reaching carbon neutrality by 2050. The plan is highly ambitious and involves dramatically reducing the use of fossil fuels. We will not enter into a discussion of how likely it is that the target will be met, but we will explain why this decarbonization policy benefits Brazil.

## Brazil's energy matrix

Our country has an electricity generation mix that is highly differentiated compared with the rest of the world. In 2021, 67.4% of global electricity was produced from fossil fuels. China generates one-third of the world's electricity, 65.9% of it from fossil fuels, with 63.2% coming from coal. By contrast, only 20.3% of Brazil's electricity comes from fossil fuels, and just 3.7% from coal.

One advantage of Brazil's electricity matrix is its lower exposure to fossil fuel price volatility. With 77.4% of our electricity coming from hydroelectric and renewable sources, we are more dependent on rainfall and other climatic factors.

Another advantage is that our energy is considerably cleaner especially compared to China. One kWh produced in China emits, on average, 541 grams of $CO_2$, while one kWh produced in Brazil emits 142 grams of $CO_2$, almost four times less. This is a meaningful differentiator for attracting countries pursuing carbon neutrality. By shifting energy-intensive industrial activities from China to Brazil, they could reduce 74% of the $CO_2$ emitted by the supply chain.

## The opportunity of this generation

It is not every day that we see Brazil emerging from a macroeconomic crisis ahead of the developed countries, occupying an extremely favorable position to benefit from the migration of important production chains, and holding an energy matrix that is now becoming highly prized given the global decarbonization agenda. This is an opportunity we should not let slip away.

Our government does not need to do anything brilliant for the country to benefit. It would be enough to demonstrate to the world that it will be a serious and responsible government, one that seeks to facilitate the development of business in the country and understands that financing populist measures through fiscal irresponsibility is a strategy that exacts its price in short order and destroys what would otherwise be strong economic prospects. In short, a governing strategy focused on not making major mistakes, rather than attempting grandiose projects, would already be an excellent start.

The counterweight to this hope is that Brazil has an unfortunate track record of squandering good opportunities. Our population still has relatively low levels of political maturity and formal education, which at times generates major public debates around issues of little practical impact for the country, while setting aside what could truly make a difference in our lives. In any case, the risk of wasting a good opportunity is always a better scenario than having no opportunity at all.

## What to expect from Lula

Now that his victory is secured, we expect Lula to reveal his choice for Finance Minister and to provide greater transparency about his government plan. The greatest risk is that Lula abolishes the spending cap and returns to policies of economic intervention, as he advocated during his campaign, but we believe that the composition of the new National Congress and the alliances forged to win the election serve as meaningful brakes on policies of this kind. If they do not prevent them entirely, they should at least delay and soften them.

Moreover, with a center-right National Congress and a left-wing president, negotiations tend to be slower and more contentious, constraining the executive branch's ability to act more broadly. It is therefore to be expected that Lula will adopt a more centrist posture, unless he falls back on the same kind of strategy he used in the past to secure legislative support in more "direct" ways.

On the positive side, Lula enjoys a strong international reputation, particularly among European countries. This is favorable for the diplomatic agenda needed to attract foreign investment and establish new international trade agreements. Lula is especially well positioned to leverage the narrative that Brazil has a clean economy, which resonates strongly with his campaign platform.

## What this means for our investments

Despite the macroeconomic lens we have adopted in this letter, our investment decisions always depend far more on the analysis carried out on each specific investment thesis.

Even without that macro bias, we ended up investing predominantly in companies that are more dependent on Brazil's domestic market than on the global economy. In part, this is because these were simpler theses to analyze in the current environment, making our future earnings estimates more reliable and in part because Brazilian exporting companies are, for the most part, commodity sellers. Despite the commodity price cycle driven by geopolitical turbulence, the trajectory of commodity prices over the coming years is unpredictable, and we believe the risk of a decline is greatest precisely when prices are trading above their historical average. Given the complicated external environment, it seems prudent to maintain a portfolio that is more dependent on the domestic market.

Share prices, as usual, were a decisive factor in the investment decisions we made this year. The Brazilian stock market remained cheap throughout the year, and we took advantage of this favorable environment to gradually buy more shares in excellent companies at significantly discounted prices.