



Market Commentary
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English Version

Insigneo Weekly Dispatch

Brazil Are We There Yet?

Get guidance on investments, and the major structural factors behind your clients' portfolios.

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Brazil – Are we there yet?

Brazil faces fiscal headwinds with expectations of a negative primary fiscal balance for the next three years and elevated public debt levels. Inflation remains a concern despite being within target, driven by a positive output gap and fiscal policies, while the Central Bank is expected to continue raising interest rates in 2025.

The Brazilian equity market experienced a challenging 2024, with the Bovespa Index declining by over 10%. Valuations are near historic lows, potentially making them attractive compared to global peers over the long term. However, persistent macroeconomic and political volatility could create further downside in the short-term, favoring a selective and long-term approach to investing.

Brazil ended 2024 on a complicated note, with challenges looming on the fiscal front that have kept investors on their toes. **The Brazilian economy, once**

seen as a powerhouse in Latin America, may be facing a degree of cooling in its recovery cycle, a byproduct of the aggressive monetary policy tightening undertaken by the Central Bank to rein in unmoored inflation expectations. Even though the country’s latest activity index reading for November posted a recovery after a slight setback in October, Brazil’s economic activity is showing its first signs of weakening in the observed decrease in retail sales and weak industrial production print for the same month.

According to the latest survey of market analysts performed by the Central Bank, the increase in the Selic rate is expected to continue with ~275bps of increases discounted in 2025. **This expectation comes despite the fact that the last inflation print was in line with market expectations and currently in line with the target range (3.00% +/-1.50).** Inflation expectations continue to deteriorate amid a positive output gap, a positive labor market gap, and pro-cyclical fiscal policies. Topping it all off, the monetary policy committee – COPOM – has a new governor, Gabriel Galípolo, who will preside over his

first meeting in January.

It is also worth highlighting that, according to the Central Bank survey we previously mentioned, analysts are forecasting a negative primary fiscal balance for the next three years – a situation that would not comply with the targets established by Brazil's Ministry of Finance. Here, it is worth remembering that **Brazil is dealing with all-time high levels of public debt, and even if FinMin Haddad has enacted efforts aimed at improving Brazil's fiscal policy, not much progress has been achieved.**

The challenging macroeconomic and fiscal environment is reflected in asset prices. After reaching a five-year low versus the USD in December, the BRL has gained some ground recently on the back of Central Bank interventions in the swap market, and discussions within the Lula administration to potentially provide reduced-cost food products through a network of stores to combat inflation and boost the president's popularity. However, this proposal may prove problematic, since it would require subsidies, which in turn may bring an additional headache to Brazil's already challenging fiscal outlook. Even if FinMin Haddad dismissed such subsidies after calling them "just gossip," the market remains vigilant of the Lula administration's measures to tame inflation without compromising the country's fiscal stability any further.

It should come as no surprise that the current situation in Brazil has also pressured its equity market. After a stellar 2023, which saw the country's Bovespa rise over 20%, last year was a challenging one. In 2024, the Bovespa gave back some of its gains from 2023 falling more than 10%. Brazilian equity ETFs fell even more.

From a valuation perspective, Brazil's IBOVESPA Index is currently trading at a forward P/E ratio of 8.1x, a sharp discount relative to its global and regional

peers. To put things in context, Mexican stocks, as measured by Mexbol, are trading at 11.6x, while the S&P 500 is trading close to 26x. **From a historical perspective, Brazilian stocks are currently trading well below their 10-year average of 14.6x, closer in fact to the low of 5.5x than the high near 40x.** These low valuation levels have many investors questioning if now is a good time to invest in Brazilian equities. The answer is complicated. Although valuations are low, this market could remain choppy in the near term. Being selective is key.

As investors exited Brazilian equity markets, most did so by selling, or even shorting, the iShares MSCI Brazil ETF (EWZ). Unfortunately, this fire-sale of the ETF has pulled down weak and strong companies alike. An example of a strong company that has been swept by the tides is **Nu Holdings (NU)**, as it represents one of the largest holdings in the ETF. Operating as NU Bank, this company offers digital banking and payment transfer services in the region. What gives NU a competitive advantage is the fact that it is successfully using fintech to offer financial services to previously unbanked populations in the region. The company has been seeing the credit quality of its borrowers improve, therefore improving the quality of its assets. At the same time, NU is further expanding its footprint in Latin America with its recent partnership with Mexico's OXXO stores, allowing it to reach an even broader market.

Within the Financial sector, two other companies that have been dragged down along with the ETF are **Banco Itaú (ITUB)** and **Banco Bradesco (BBD)**. With a highly diversified revenue stream, Banco Itaú is one of the largest banks in the country. By offering banking services to both consumers and businesses, Itaú should benefit from increased spending in the country over the long term. At the same time, the bank's exposure to a strong fee-based wealth management business provides a degree of diversification from traditional banking. Much like Banco Itaú,

Banco Bradesco should also benefit from increased consumer spending in the country over the long term. The bank's heavy focus on the domestic market, coupled with the implementation of cost-cutting measures, should improve margins over time. Additionally, through its diversified insurance arm, Bradesco also owns the country's largest insurance business, which gives the bank an additional growth engine.

Lastly, a company that appears attractive within the Industrials sector is **Embraer (ERJ)**. Embraer is a manufacturer in the aerospace and defense industry, with a strong competitive advantage in its main business lines. Within the aerospace industry, Embraer is cornering the short-haul aircraft manufacturing industry, an industry that is seeing growing demand. Within the defense industry, Embraer has successfully positioned itself as a leading supplier of aeronautical systems in the region. Defense spending is likely to increase in the region and the entire world, which could increase the company's revenue. An example of this is Uruguay's recent purchase of 5 Super Tucano aircraft announced earlier this month. It is important to note that Embraer is not part of the iShares MSCI Brazil ETF.

Although the Brazilian equity market is likely to move higher over time from its near record low val-

uation level, it is likely to be a very bumpy road. Interest rates in the country are likely to remain higher for longer, and the political environment is likely to remain volatile, at least up to the presidential elections in 2026. As a result, considering investments in the Brazilian equity market is best suited for investors with a high tolerance for risk and a long-term investment horizon. Additionally, investors looking to get exposure to this market could consider doing so through professionally managed, more diversified investment vehicles. Lastly, it is important to note that the individual stocks referenced here may exhibit high degrees of volatility and are best suited for investors with a long investment horizon and a high tolerance for risk. Please consult with your financial advisor to determine your individual suitability. ■



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