06/04/2021: *The Economist* Fade… Brazil Edition

A macro call is embedded into *nearly* every investment, whether one is aware or not. Druck's protege, Scott Bessent puts it like this:

> *I was at a money manager roundtable dinner where everyone was talking about "my stock this" and "my stock that". Their attitude was that it doesn't matter what is going to happen in the world because their favorite stock is generating free cash flow, buying back shares, and doing XYZ. People always forget that 50% of a stock's move is the overall market, 30% is the industry group, and then maybe 20% is the extra alpha from stock picking. And stock picking is full of macro bets. When an equity guy is playing airlines, he's making an embedded macro call on oil.*

This is particularly true when investing in emerging markets, where macro is by far the dominant driver of returns. For example, a common macro misconception regarding EM is that its historically high growth rates equal better investment returns. This idea has been *categorically* proven false.

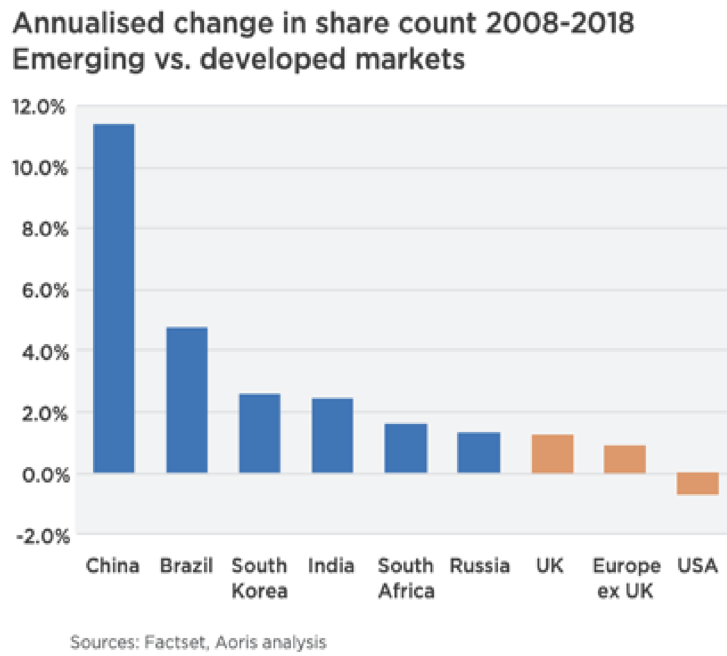
Jason Zweig published an article in the *WSJ* (link here) a few years back commenting on a *Financial Analysts Journal paper*. He highlighted an important and often misunderstood fact: high GDP growth does not entail high stock market returns; in fact, it's often quite the opposite. Zweig writes:

> *History shows that countries with faster-growing economies often produce lower—not higher—stock-market returns.*
>
> *"If you told most investment professionals that you would give them future dividend yields, inflation and economic growth rates, they would probably believe they could rank the future stock returns across countries very well," Mr. L'Her says in an interview. "That has not been the case in the past 20 years—not by far."*
>
> *He adds, "Even if you'd had perfect foresight into such factors, you would have done a very poor job forecasting the differences in returns across stock markets."*
>
> *One component of return swamped all others in predicting returns: whether the total supply of shares was contracting or expanding. That alone, says Mr. L'Her, explains more than 80% of the extent to which returns have diverged across stock markets over the past 20 years.*

EM companies are notorious for fleecing shareholders. Despite being situated in high-growth economies, their dependency on investor capital is why "*over the last decade real EPS at an index level has more than halved in three of the five largest emerging markets,*" as Aoris Investment Management points out in this deep dive (link here).

This is the macro version of what Fama and French termed the “asset-growth anomaly,” which the book *Capital Returns* explain as thus:

> *...Corporate events associated with asset expansion — such as mergers and acquisitions, equity issuance, and new loans - tend to be followed by low returns. Conversely, events associated with asset contraction - including spin-offs, share repurchases, debt prepayments and dividend initiations - are followed by positive excess returns.* ***The negative impact on shareholder returns from expanding corporate assets was found to persist for up to five years.***



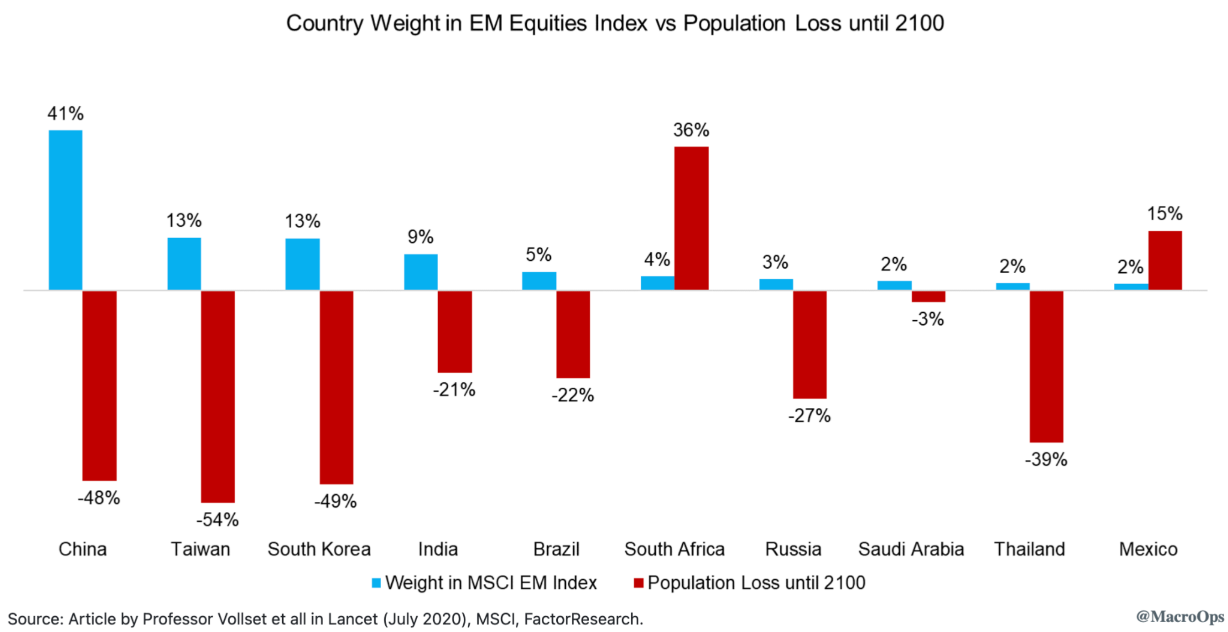
> *… In short, recent research is edging towards the conclusion that the excess returns historically observed from value stocks and the low returns from growth stocks are not independent of asset growth.* ***This leads to a key insight of the capital cycle investment approach: when analyzing the prospects of both value and growth stocks, it is necessary to take into account asset growth, at both the company and the sectoral level. One researcher goes so far as to claim that the value effect disappears after controlling for capital investment.***

Those who’ve ridden with us a while know that *most* emerging market economies will not see the high real growth rates of the past because they (1) are balance of payment constrained, (2) have maxed out their shares of global exports, and (3) have accumulated significant debt burdens over the last 20-years — you can read up more on this here.

Investing in emerging markets has other downsides as well. EM’s are largely correlated to US high-yield, meaning they offer poor diversification. Not to mention their demographic outlook is quite terrible. Factor Investor points this out with emphasis by me (link here).

> *Three markets namely China, Taiwan, and South Korea constitute 67% of the stocks in the MSCI EM index.* ***Each economy is expected to lose approximately 50% of its population until 2100, which is a cumulative 720 million people.***
>
> ***The top 10 countries, representing 93% of the index constituents, are expected to lose 1.1 billion people over the next 80 years.*** *In fact, only two out of these ten countries, South*

Africa and Mexico, are forecasted to increase their populations, representing only 5% of the index constituents.



Why bother investing in EMs when faced with so many structural headwinds?

Well, they still -- on *occasion* -- offer excess returns. Keyword being: occasion.

That occasion is the right macro conditions, which are:

1. Immediately following a global crisis
2. In a US dollar bear market

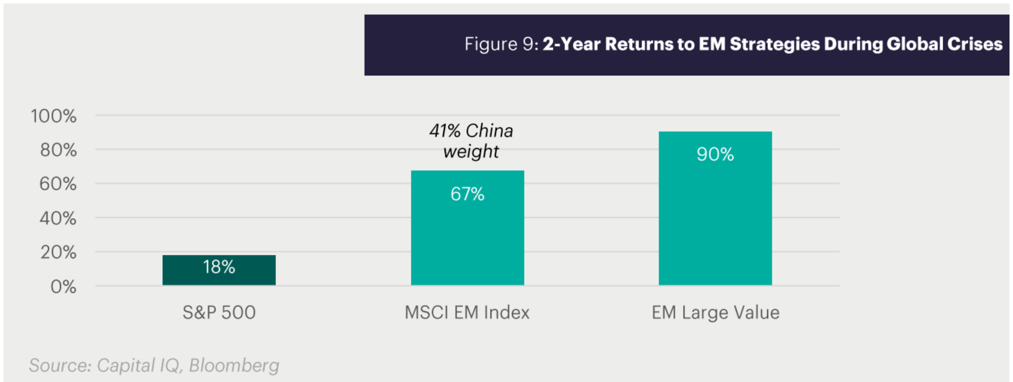
Are there exceptions to this rule? Sure... and those exceptions will become more numerous as EM's develop over time. They'll create more homegrown secular growers (global tech companies like BABA and MELI), they'll benefit from financial deepening and the broadening of their local investor bases. But, for the most part, this framework holds true and will for a good while.

Let's discuss…

Verdad Advisers put out a report a while back where they studied every EM crisis since 1987 (71 crises in total in 18 different markets). They found that the only time it makes sense to invest in emerging markets is in the 2-years immediately following a global crisis. Verdad writes:

> *We found that excess returns in EM equities were most dramatic after global crises. Investing in EM equity indices during global crises would have returned on average 91% over 2 years,*

with an 84% chance of positive returns versus 23% for the S&P 500 and a 75% chance of positive returns.

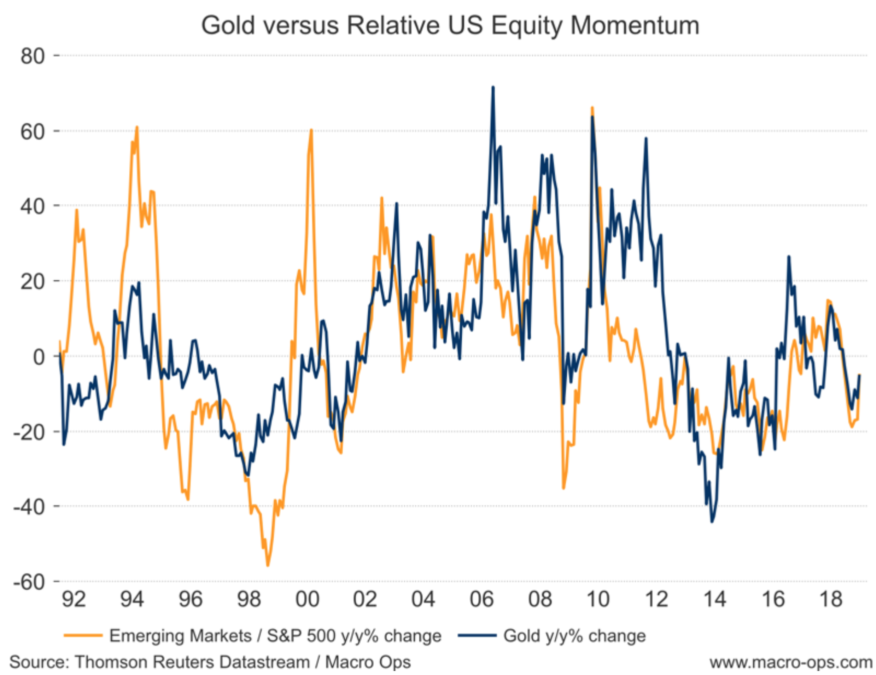


You can find the full report [here.]()

We can further improve this screen by only looking at EMs following a crisis while *also* in a cyclical USD bear market.

Every macro trade is a dollar trade in some sense. This is especially so for emerging markets, mainly for the reasons outlined in the Balance of Payments Constrained report. EMs depend on US dollar flows to finance projects/growth and are subject to its whims... But again, this will become less relevant for some EMs in the decades to come as they become less reliant on USD funding.

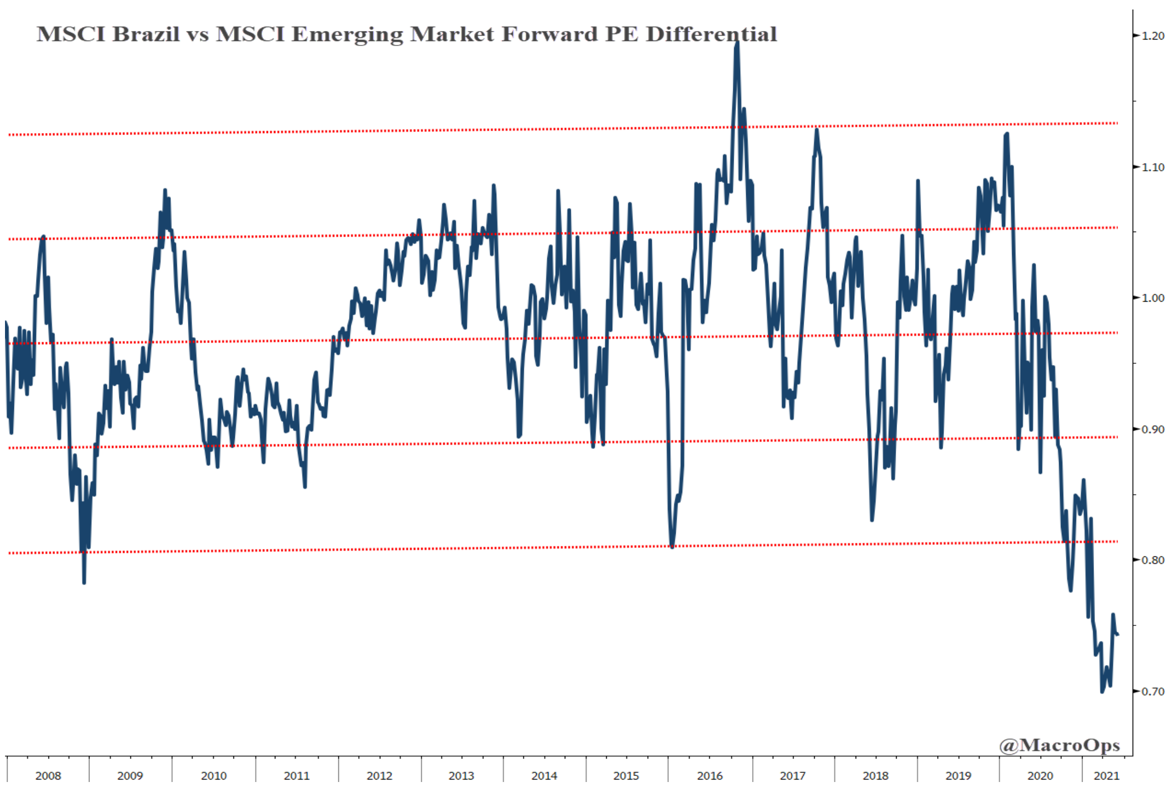
But, alas, that's still a ways away for most, and until then, we can expect EMs to act as a synthetic short USD trade. The chart below is evidence. EM year-over-year performance relative to SPY (orange line) versus gold, which is another anti-USD asset.



Anyways… We're roughly one year post-crisis — at least as measured in financial market terms — and we're still in the *early* innings in a cyclical USD bear market. This means we should expect at *least* another year of relative outperformance from emerging markets.

Over the last 9-months, we've discussed why Mexico (link here) is our favorite expression of this trade (best demographics, geography, politics mix, etc...). But there are a few other, more idiosyncratic setups that offer some intriguing opportunities as well. Brazil is one of them.

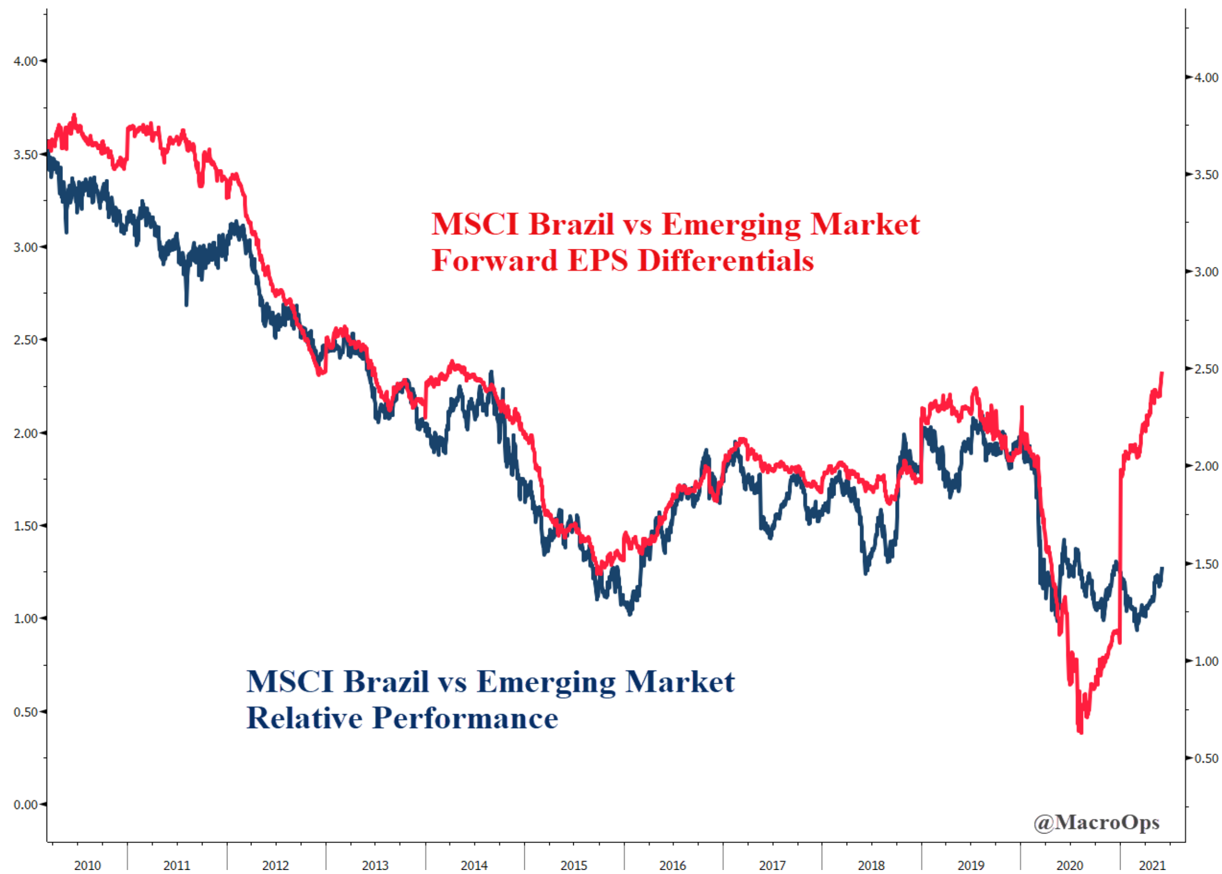
Brazil has suffered several self-owns over the last year, thanks mainly to domestic politics and its poor handling of the coronavirus. This has tarnished investor sentiment towards the home of the Carnival festival. Such negative perception has driven Brazil's relative forward PE differentials with MSCI EM **more than 2stdev below its 15-year average.**



I'm always interested in opportunities where the market overly discounts a narrative. That narrative eventually becomes entrenched, and then due to inertia, the market fails to see that the facts on the ground have started to change.

Brazil is a great current example of this.

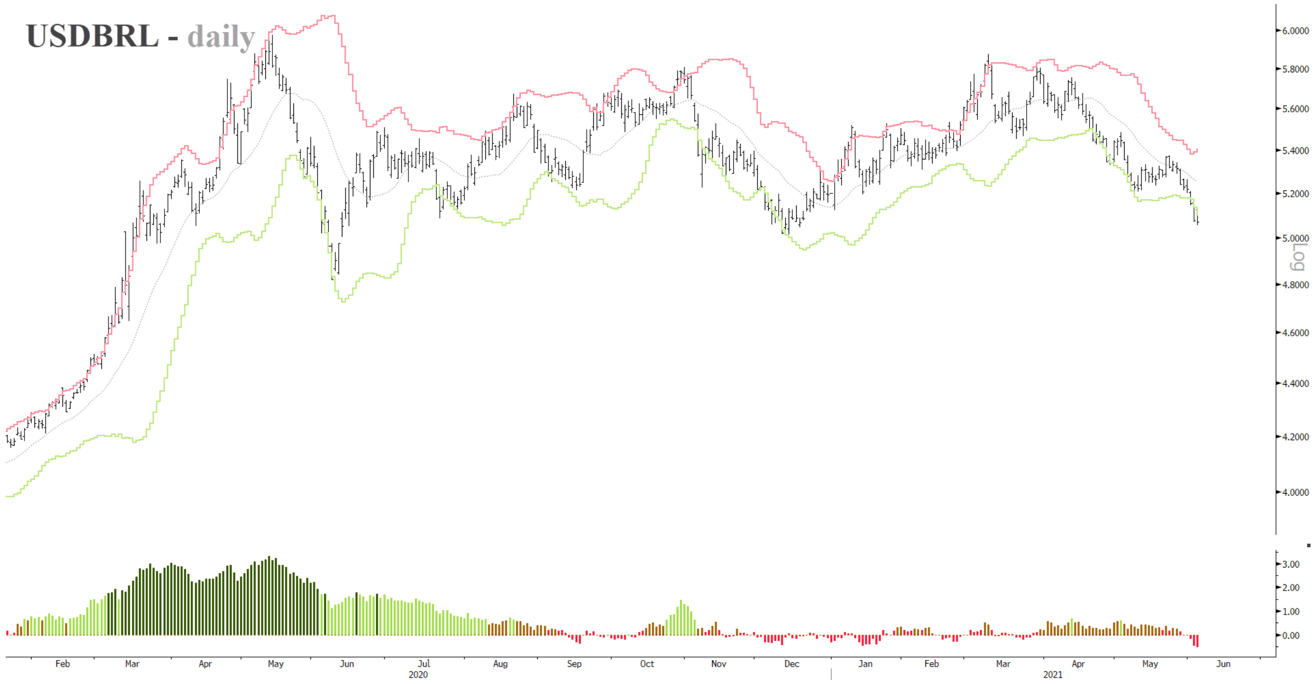
Take a look at its relative forward EPS differentials with EEM. They've been inflecting higher in Brazil's favor for the last 7-months, yet Brazil's price differentials have traded sideways (h/t @MrBlonde_macro).



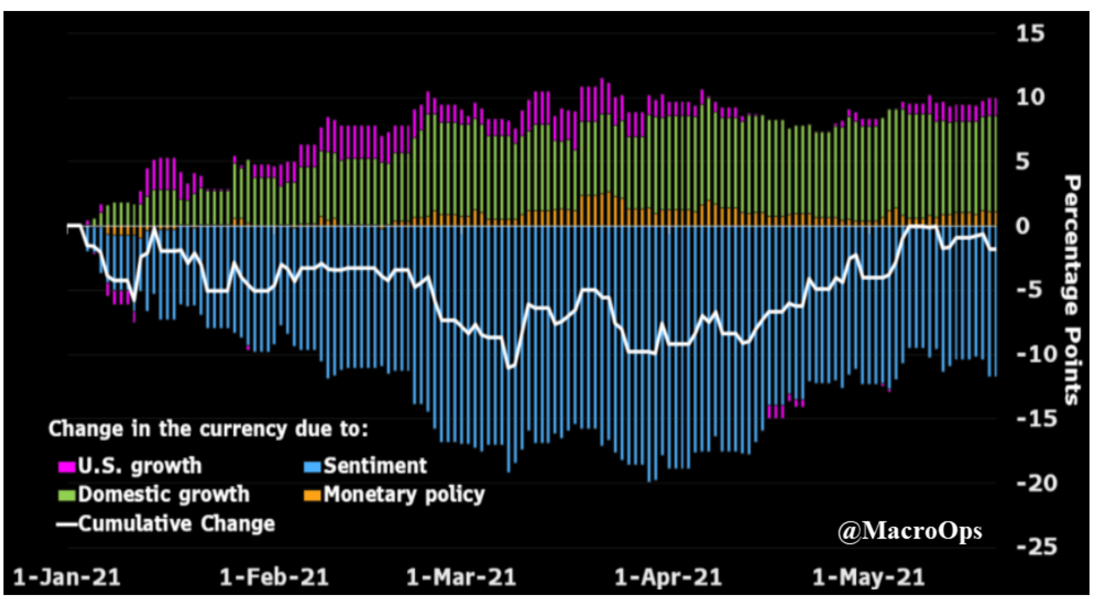
This price anchoring is primarily due to the relative weakness of the Brazilian Real. Remember this bit from our currency framework (link here)?

> ***Speculative capital moves in search of the highest total return.*** *The total return is made up of:*
>
> 1. *Exchange rate differentials*
> 2. *Interest rate differentials*
> 3. *Local currency capital appreciation*
>
> *Of the three, exchange rates are the most important because they tend to fluctuate more than interest rates or relative market returns. It doesn't take much of an exchange rate decline/increase to completely overshadow the return on interest rates or capital appreciation.*

The Real was among the weakest EM currencies in the first quarter of this year and didn't begin to strengthen until late March (chart below is weekly USDBRL). This has helped reinforce the stigma investors have towards investing in the country.

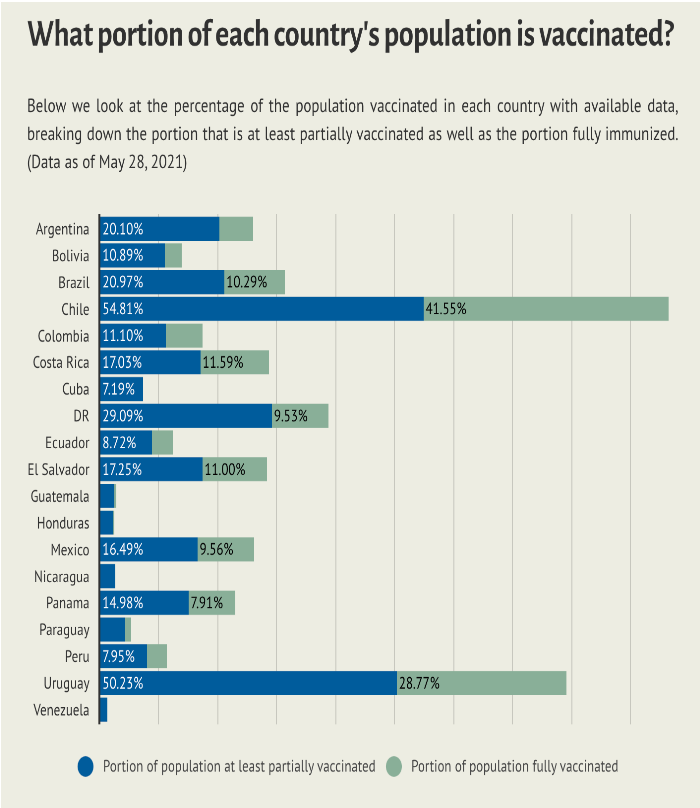


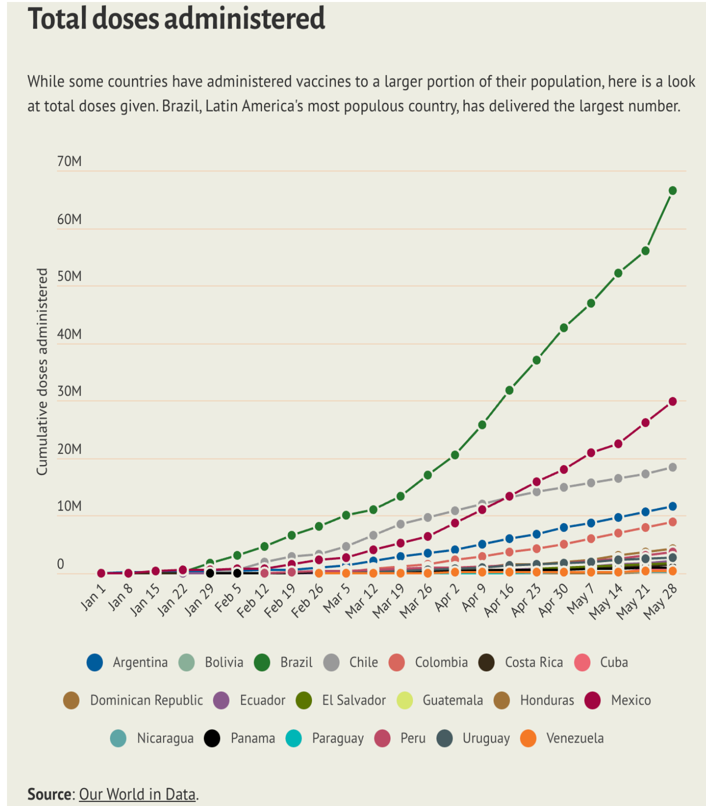
Driver attribution of the Real shows that negative sentiment is the lone reason for the Real's weak year-to-date performance. Growth has inflected higher, and so has Brazil's yield differentials. Absent this dour sentiment, the Real would be trading at much stronger levels (chart via BBG).



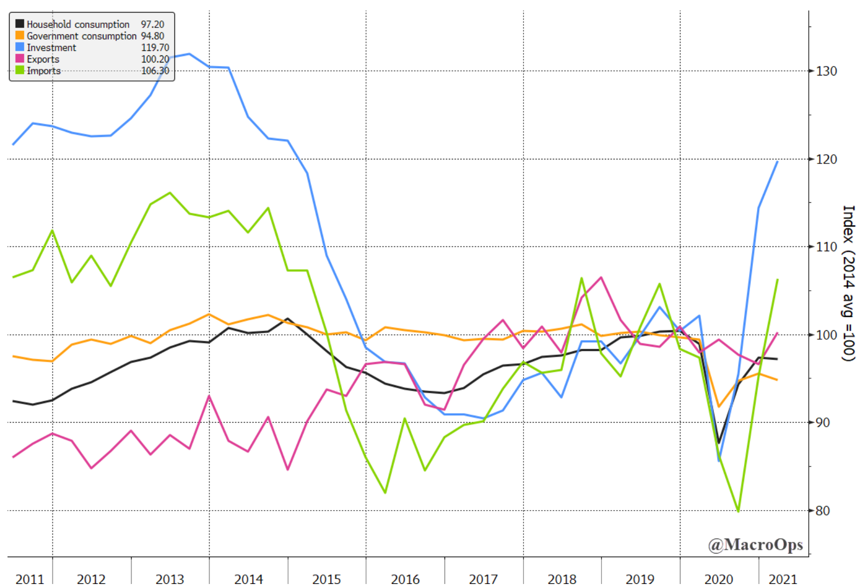
The good thing is that sentiment can only stay in opposition to changing fundamentals for so long. Eventually, the inertia will snap, and the repricing will be swift.

The improving vaccination rates will be a significant driver of this. New cases in the country peaked back in late March and have been steadily trending lower.





Growth has rebounded and is inflecting higher, with the recent GDP numbers blowing away consensus estimates. The turnaround is being led by a significant pick-up in investments.

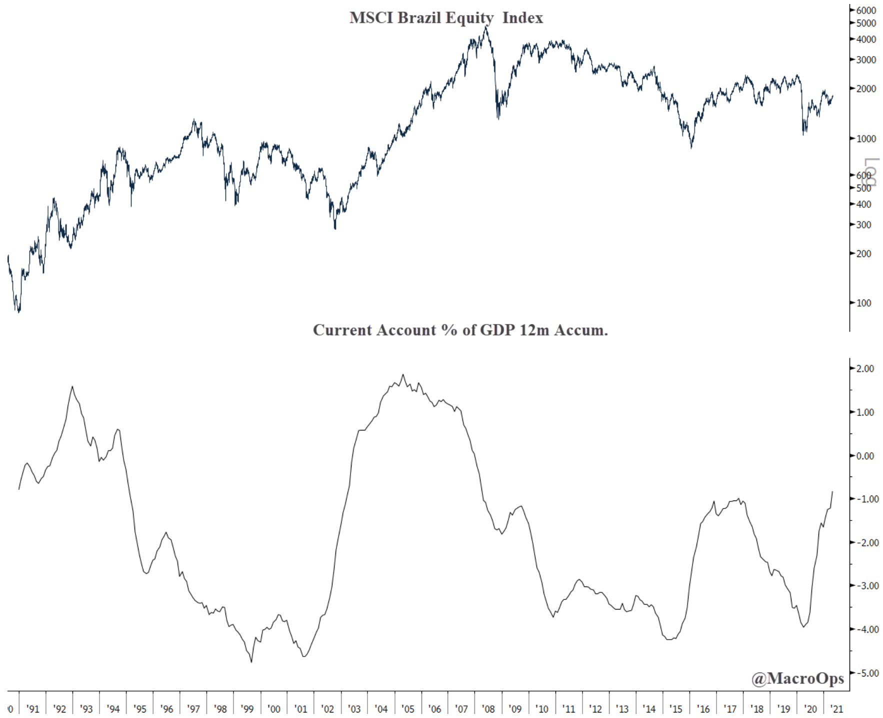


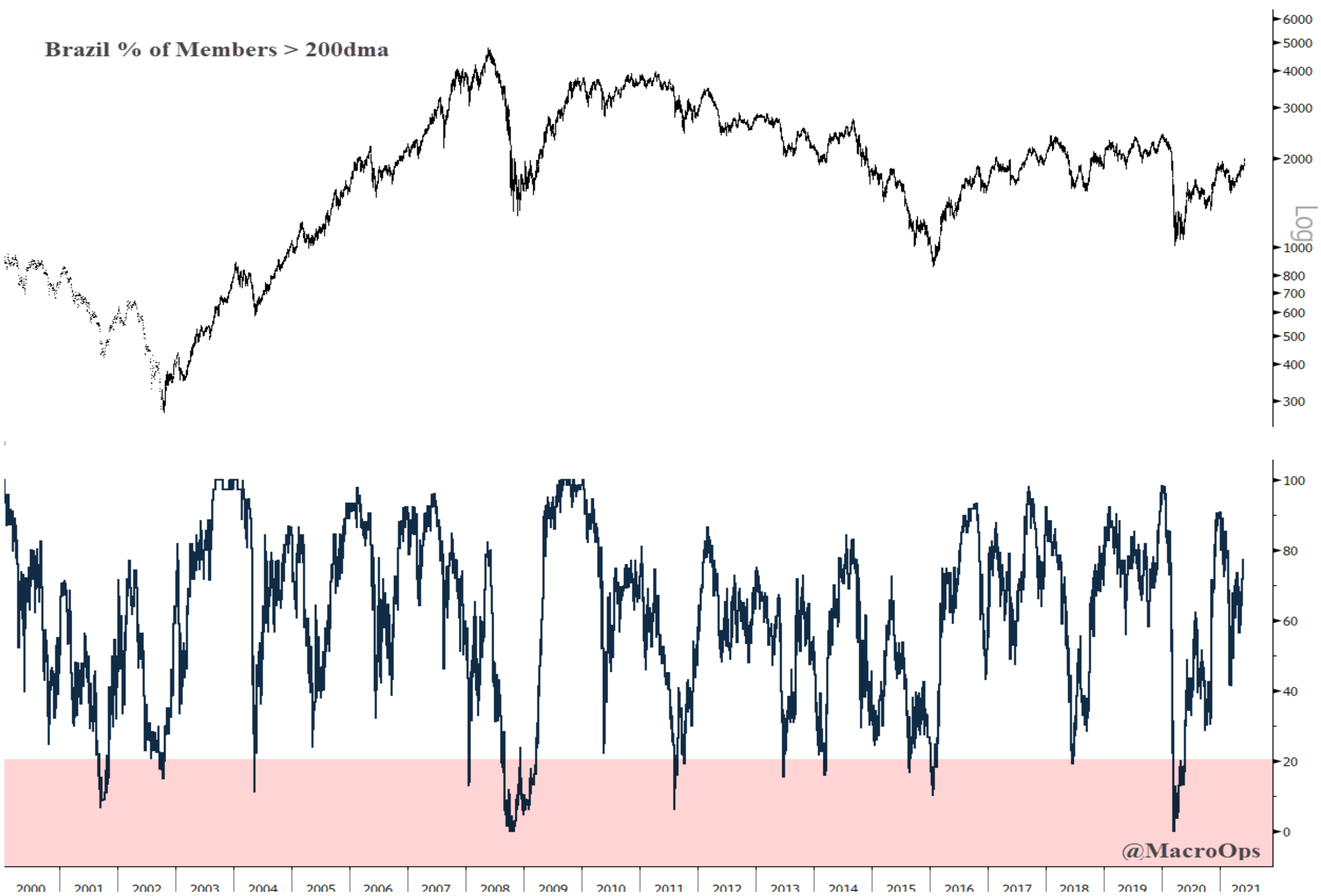
More importantly, Brazil has been making several significant political and institutional reforms over the last few years.

They successfully overhauled their bloated pension system in 19' and recently approved a measure promoting central bank autonomy as well as a needed fiscal emergency law.

The country's current account position is improving, precisely what we want to see for a <u>sustainable</u> EM recovery.

Long-term breadth is trending higher, supporting the cyclical trend up.

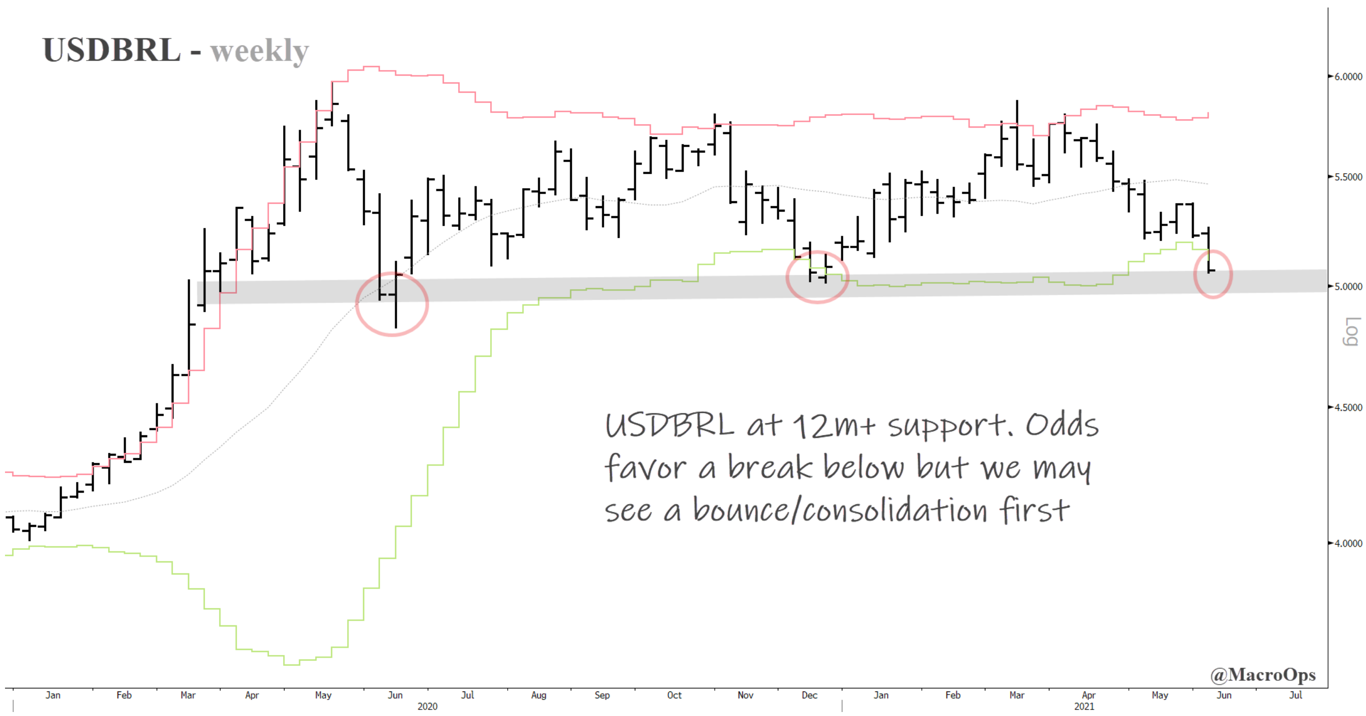




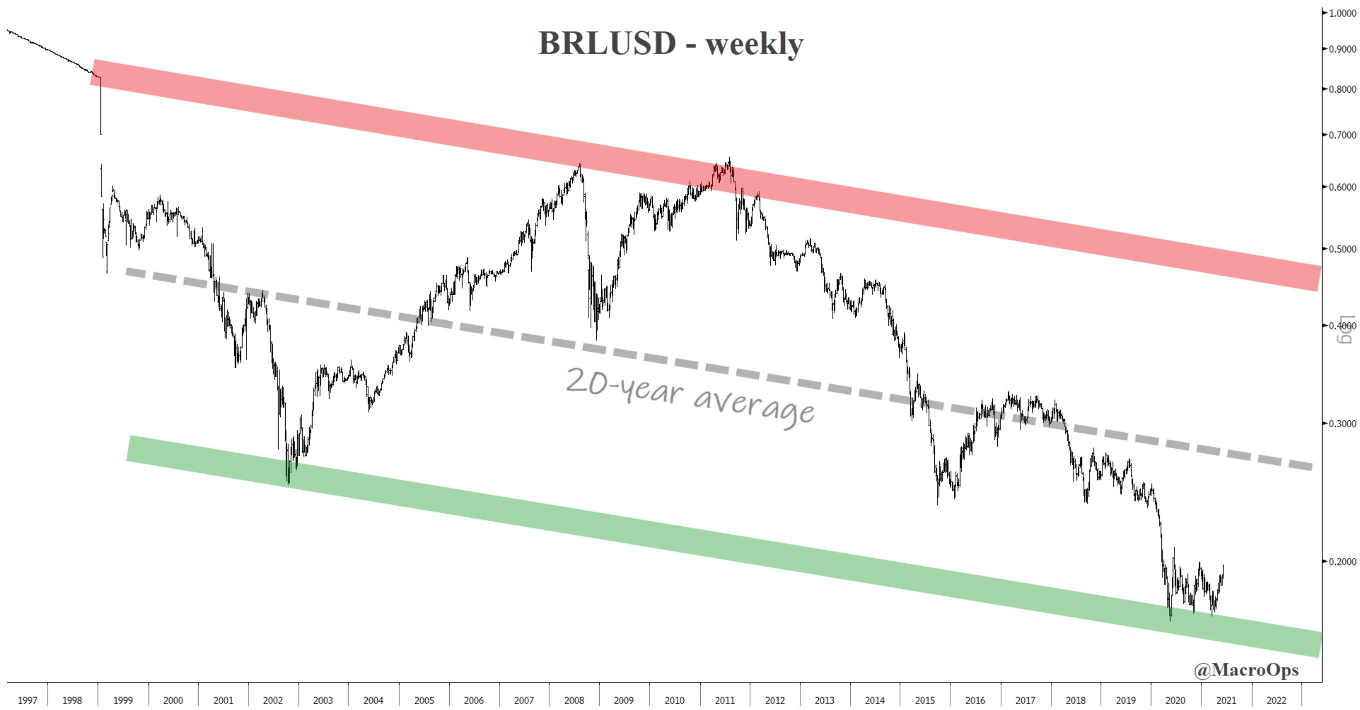
This setup gives us many conditional edges in getting long Brazil.

We have a supportive macro regime in that we're within the 2-year window following a global crisis while *also* in the early stages of a cyclical USD decline. Moreover, the country's fundamentals are inflecting higher on an absolute and relative basis. And the only thing keeping prices from outperforming is sentiment-induced inertia, which won't be able to hold much longer.

At this point, it's a matter of when and not if... What I'm looking at for timing is how the Real reacts at this longer-term support level. USDBRL is knocking on 12-month support as well as its lower weekly Bollinger Band.



The **LONG...** long-term chart shows BRLUSD (flipping the pair for illustrative purposes) has consolidated on the lower bound of its 20yr+ channel line. **Thus, the odds strongly favor some mean reversion to at least its 20yr average, if not much higher** (h/t Nautilus Research).



The USDBRL tape looks heavy, but I wouldn't be surprised if we see it consolidate or maybe bounce here and work off some of its short-term technical overextension before a move lower. Broader short positioning in USD has gotten a bit crowded, making it susceptible to snapback moves. And, if our *Summer Doldrums* thesis plays out, it'll be an impetus for that type of move.

We're positioning for this trade through Telefonica Brasil (VIV) (report here). Still, we may add a BRL long if given a good technical entry point.

VIV is an exciting name. The stock has a lot going for it. It's trading at a deep value, has a sticky customer base with solid growth, is backed by a rock-solid balance sheet which is unusual for a Telco operator… And importantly, has shareholder-friendly management, which shows through with its aggressive buyback and dividend policies.

We'll look to add on technical setups as this story plays out.

Finally, I'll leave you with this…

Stay safe and keep your head on a swivel.

Your Macro Operator,

Alex