Brazil & Petrobras

The life of an emerging markets fund manager never runs smoothly. Sometimes it is as mundane as a stock you own missing your earnings expectations, other times the El Niño may cause a country's whole economy to be unexpectedly weak.

However, when the President of a country does something that causes immediate and fundamental damage to the economy, what do you do? This week we had one of those moments in Brazil.

President Bolsonaro moved to replace the CEO of Petrobras, Roberto Castello Branco with a retired General over the weekend. He has also threatened changes in other State-Owned Enterprises (SOEs), including the electricity sector. On Monday, Petrobras opened 22% down in New York trading and the carnage rapidly spread beyond the SOE's to the broader Brazilian market.

Beyond a few comments along the lines of "It's Brazil what do you expect", no-one could claim they saw it coming, which explains the violent reaction.

Like other investors, we listened in on experts' calls, heard analysts explain their double downgrades (Buy to Sell, skipping the intermediate Hold) and dramatic price cuts. Was this a rerun of (former President) Dilma Rousseff's disastrous interference? Is this a right wing Chavez/ Maduro (Venezuela)? Is this a buying opportunity?

Comparisons to Chavez and Maduro are excessive. Brazil has a history of successfully impeaching Presidents, and its congress is too fragmented between multiple parties to enable a single one to mount a putsch. Its institutions are dysfunctional, but their power is strong.

Bolsonaro has also been here before - he cancelled a gasoline price hike in early 2019 then reversed himself after a week of “consultation”.

Bolsonaro is struggling with very low popularity – 40% disapproval, 32% approval - as the election cycle starts up (next elections Oct ‘22) and a trucking strike seems inevitable after the fourth increase in fuel prices in a month.

Dilma faced a similar strike over rising fuel prices. Although the truckers were initially unpopular, they became a focus for the growing disapproval of her Presidency. Some consider the strike as the final straw that led to her eventual impeachment. Her interference in petrol prices forced the Petrobras to subsidize imports, resulting in massive losses at exactly the time the company should have been making good profits. In 2015, the company lost close to $8.5 B, resulting in fewer taxes and dividends transferred to the state. It is the reason Petrobras became so indebted, threatening not only the solvency of the company itself, but also the country itself.

Castello Branco was put in place originally by Bolsonaro precisely because he had a reputation as a technocrat, and his presence would reassure the markets that the government was going to follow rational pricing.

The problem is uncertainty. What is going to happen? Answers are not immediately apparent.
There has been no idea from Bolsonaro what he wants changed, just that he wants change because the board isn’t working. He has even said he doesn’t want to change the pricing mechanism, he just wants more transparency. At the same time, he accused the management of being cowards for not putting Brazilians first. Everyone *assumes* he intends to change the pricing mechanism, but exactly how is a mystery.

Petrobras has lots of liquidity on its balance sheet. It is not in immediate or even near-term risk of insolvency. The recent story was one of selling excess refineries, pipelines, and other assets to pay down the ridiculous levels of debt run up under Dilma. Earlier this month, they successfully sold off one refinery and felt confident enough to reject bids for another that it deemed too low. Domestic prices have been following the international price for oil higher, and that appears to be the root cause of the problem. If he is worried about inflation rather than the trucker’s vote, his action will inevitably accelerate it, and the more he interferes, the more it will accelerate.

If the government uses this as an opportunity to finally introduce a *realistic* price-smoothing mechanism, that could be seen as positive from this low base. The proposed CEO General Silva e Luna talked about a “cushion” on the radio, but historically those only work well when prices rise, but not so well when they fall, and the market is in no mood for asymmetric risk. They might conceivably reduce the taxation on diesel whilst allowing other prices to rise, which could again be seen as positive after this selloff if handled correctly. IF…

Fears over similar intervention in the electricity sector center around the distribution companies most of which are private companies. Their tariffs are linked to IGPM inflation (general inflation) which is picking up again. Will Bolsonaro break those contracts, and if he does, will he stop there? Will he also break the concession contracts for the toll-roads that are linked to the same inflation contracts? Where does it end?

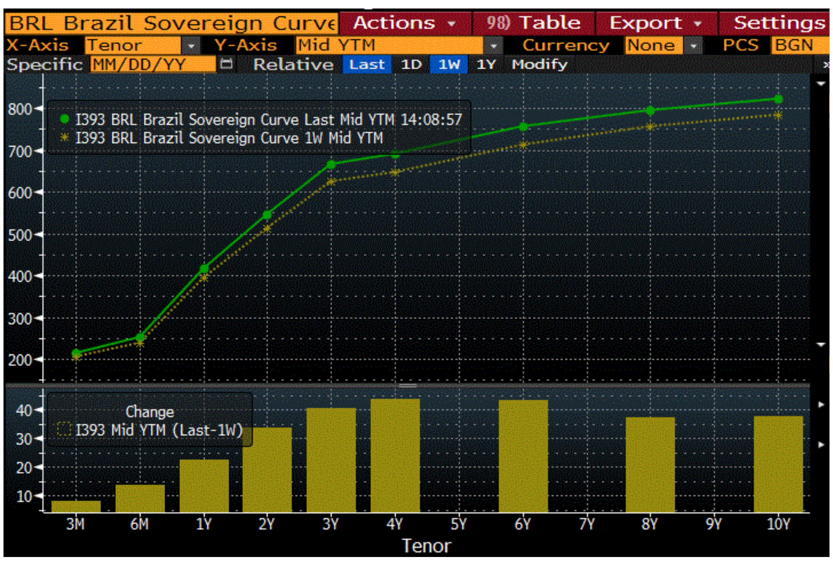
The Left never broke any of the concession agreements no matter the pressure. Luis Ignacio Da Silva (Lula) went toe-to-toe with one of the governors who wanted to break toll road concessions in Parana state. So, tearing them up would give the opposition a very big stick to hit Bolsonaro with ahead of the elections.

One fear is that Minister of Finance Paulo Guedes might leave, which would spell the end of any serious reforms. Ironically, both chambers of the senate elected reform-minded leaders earlier this month, so the opportunity for reform hasn't been so high. Both chambers have passed a bill to grant the central bank (BCB) complete autonomy, and Bolsonaro said today he will sign it on Wednesday this week, which is earlier than expected. Guedes has pointedly not said anything, which suggests he is letting the President stew.

BCB autonomy is a good idea and will be tested soon. March 17th is the next COPOM (rate setting) meeting. We had this as a key date already as we were expecting a 25 bps rate increase, but the market is now pricing in 50 bps, with a total of 350 bps increases this year. There is little doubt now that BCB needs to get ahead of inflation quickly, and this move by Bolsonaro makes that job harder. If they do act decisively, positive real yields, increasing commodity prices, and ample dollar liquidity should lift the currency. If they don't get ahead of inflation quickly, Bolsonaro will probably end his term as President, presiding over yet another fiscal crisis

So far, we haven't seen a blow out in CDS spreads or a major shift in the yield curve - see below. The currency (Real) fell by about 2.7% before BCB started offering currency swaps that cut the fall to about 1.5%. Currently, the Real is where it was back at the November level that most people consider cheap. That means the currency has given back all the gains it made in the reopening rally. There doesn't seem to be a stampede for the exit, but people certainly want to know where the door is.

Source Bloomberg



Source Bloomberg

The best guess price for the locals (PETR3) after all the weekend's double downgrades was R$24, and the stock closed at R$21.69 Monday. In last March's end-of-the-world collapse in global markets, the share price got down to R$12, then rallied to R$19 before the reopening rally. Dollar targets after the same multiple downgrades are about 30% higher than Monday's according to FactSet, so there is an incredible amount of bad news priced in.

Vaccine availability is expected to increase significantly over the next several months. It won't reach Chilean standards for roll-out, but, at this point, pretty much anything will be an improvement.

Brazil does have a habit of doing some of the right things when its back is to the wall, and after today's moves in the markets, Bolsonaro has to be under no illusion that he has put Brazil's back to the wall.

Petrobras has been routed. The question now has to be what would it actually take to justify the current price? We would probably need to see reversals of several recent gas price hikes probably to the point of negative margins. This is unlikely (but not impossible). Any reasonable indication that some/ most of the recent price hikes will hold will boost the stock.

None of that makes this a slam-dunk buying opportunity - sadly.

There are no two ways about it, this is a major own goal by Bolsonaro. If he can mess up this badly, he can do it again. Although the market has probably overreacted at this point, it probably hasn't gone far enough to justify backing up the truck to load up shares of Petrobras.

If the COPOM raises by 50 bps on the 17th, the stock will probably rally along with the currency as it will appear that political risk has diminished, and there are still some adults around. Sadly, if they don't raise at all, it will be "game over".

Binary outcomes like this are a fund manager's worst situation. Whatever we do, we are going to be wrong. If the news turns positive, we won't have enough of the stocks rallying; if it turns negative, we will have too many of the same stocks.

The decision comes down to minimizing risks for the client. In this case, reducing the risk of losses. As much as we love Brazil and the Brazilian people, we have to do what is right for our clients. Clients come first, last, and always. The risk in Brazil has clearly gone up dramatically, so we have a duty to our clients to reduce exposure until we have greater clarity.

Mount Murray Investment