

Brazil Backslides

May 2017

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- Brazil's President is alleged to have implicated himself in a recording depicting his approval of a bribe.
 - The latest revelation was not received well by investors—stocks plunged, bond yields increased (bond yields and prices move inversely), and the Brazilian currency dropped—before mounting a partial recovery.
 - We believe the accusation will be a shorter-term impediment to Brazil's longer-term growth story.
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Political discord has resurfaced in Brazil, ensnaring President Michel Temer with claims of involvement in an illicit payoff scheme.

While this may trigger a sense of déjà vu, President Temer initially avoided any direct claims of impropriety in a sweeping probe that scandalised an entire class of politicians and business leaders in recent years. Now, he appears to have implicated himself in a recording allegedly depicting his approval of a massive hush money bribe.

Background

Brazil arguably represented one of the most attractive up-and-coming investment destinations in the world leading up to 2014. The B in the BRICS acronym used to reference the major emerging economies group that also includes, Russia, India, China and South Africa is a net oil producer with seemingly stable, if imperfect, institutions, rapid growth, and a relatively young population with a penchant for leap-frog-style modernization afforded by the mobile technology gains of recent years.

Then a heavy two-punch combo landed in 2014 from which Brazil has only recently begun to show signs of recovering. Global oil-supply gains went unrequited on the demand side, leading to deteriorating conditions for producers as energy prices began to slide in mid-2014.

Brazil's Federal Police launched the "Operation Carwash" investigation around the same time, exposing a corrupt payment network at the high-level intersections of business and politics. So far, 179 indictments have been issued, with 93 convictions across 16 companies and the Brazilian government.

President Temer came to office in the wake of his predecessor's impeachment and removal. He has already been subject to corruption claims prior to the latest allegations. Outside of Brazil, however, he was perceived as a potential catalyst for stability and reform in a country that desperately needed both.

Market Reaction

The latest accusations were not received well by investors: Brazilian stocks plunged on May 18, 2017—the day the recording's existence was first alleged—with trading halted temporarily on the Bovespa (Brazilian stock exchange). The Ibovespa Index, which serves as a key measure of the Brazilian stock market, partially recovered, but still closed 8.8% lower on the day in price-return terms. Brazil's currency, the Real, slid by 7.16% versus the U.S. dollar, and Brazilian sovereign bond yields spiked higher.

What's Next?

Brazilian opposition parties have already filed an impeachment request and called for President Temer to resign. He has denied the accusation, promised to fight and ruled out resignation. Meanwhile, Brazil's Supreme Court has authorised an investigation.

The next presidential election will take place in late 2018. If President Temer takes significant heat, but neither resigns nor suffers impeachment, then he will likely limp through the rest of his term as the country focuses on the next election.

Early elections are possible. Brazil's electoral court was already scheduled to rule in early June on whether the 2014 presidential election should be invalidated on the grounds of illegal campaign contributions. If that comes to pass, Brazil's constitution would require a new indirect presidential election within 30 days.

SEI's View

The investor-friendly reform timetable will be set back by these revelations, but we believe there's widespread acceptance within the Brazilian government that public spending needs an urgent fix. Pension reform is at the front of the line, and we see little reason to suspect that will change based on the latest allegation.

We believe the likelihood that President Temer will be followed by a serious reformist—if elected

indirectly by Brazil's Congress—is quite high, which bodes well for a continued move toward greater government spending control.

With respect to capital markets, it's important to maintain context. The Ibovespa Index was approaching the upper end of its ten-year range when the latest allegation was levelled, having rallied a stunning 79.4% over the last 16 months. The May 18 decline was indeed sharp, but there was no follow through the next day as the Index rebounded by about 3% (as of noon ET). Similarly, the real recovered by about 2.5%.

We suspect the accusation against President Temer will prove to be a temporary impediment to Brazil's continued recovery. Its investors have weathered worse over the last three years, and even his

premature departure from office could lead to a positive outcome in a more favourable replacement.

As such, the recent selloff and others that may materialise as the story unfolds could prove to be buying opportunities.

Our Funds

SEI's positioning within Brazil is mixed. As Exhibit 1 depicts below, we have notable overweights in our multi-asset income fund (which has a naïve benchmark that doesn't reflect our long-term strategic emerging-market allocations), and our emerging-markets equity fund. Our emerging-markets debt fund has a significant underweight.

Most of our funds with exposures to Brazil, however, are close to benchmark weight (+/- 50 basis points).

Exhibit 1: Fund Exposures to Brazil as of April 30, 2017

Fund	Fund Exposure	Benchmark	Benchmark Exposure	Relative Exposure
SGMF Global Multi Asset Income Fund	2.54%	40/30/30 MSCI ACWI Index (Net)/BofA Merrill Lynch US High Yield Constrained Index (USD)/Bloomberg Barclays Global Aggregate Index, Hedged (USD)	0.36%	2.18%
SGMF Emerging Markets Equity	8.14%	MSCI Emerging Markets Index (Net) (USD)	7.43%	0.71%
SGMF Global Fixed Income	0.46%	Bloomberg Barclays Global Treasury Index (USD)	0.00%	0.46%
SGMF U.S. Fixed Income	0.53%	Bloomberg Barclays US Aggregate Bond Index (USD)	0.09%	0.44%
SGMF Global Opportunistic Fixed Income	0.41%	Bloomberg Barclays Global Aggregate ex-Treasury Index (USD)	0.13%	0.28%
SGMF Euro Core Plus Fixed Income	0.28%	Bloomberg Barclays Euro-Aggregate Bond Index (EUR)	0.01%	0.26%
SGMF U.K. Credit Fixed Interest Fund	0.23%	BofA Merrill Lynch Sterling Non-Gilt Index (GBP)	0.00%	0.23%
SGMF UK Core Fixed Interest	0.15%	BofA Merrill Lynch Sterling Broad Market Index (GBP)	0.00%	0.15%
SGMF Global Short Duration Bond Fund	0.10%	Bloomberg Barclays Global Treasury 1-3 Year Index (USD)	0.00%	0.10%
SGMF Global Equity	0.09%	MSCI World Index (Net) (USD)	0.00%	0.09%
SGMF Fundamental UK Equity Fund	0.00%	FTSE All Share Index (GBP)	0.01%	-0.01%
SGMF Quantitative UK Equity Fund	0.00%	FTSE All Share Index (GBP)	0.01%	-0.01%
SGMF UK Equity	0.00%	FTSE All Share Index (GBP)	0.01%	-0.01%
SGMF Liquid Alternative Fund	0.00%	BofA Merrill Lynch US 3-Month Treasury Bill Index, 100% Hedged	0.02%	-0.02%
SGMF High Yield Fixed Income	0.00%	BofA Merrill Lynch US High Yield Constrained Index (USD)	0.06%	-0.06%
SGMF Emerging Markets Debt	5.78%	50/50 JP Morgan EMBI Global Diversified Index & JP Morgan GBI EM Global Diversified Index	6.79%	-1.01%

Source: BlackRock, SEI

Glossary

Basis point: 100 basis points equals one percent.

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