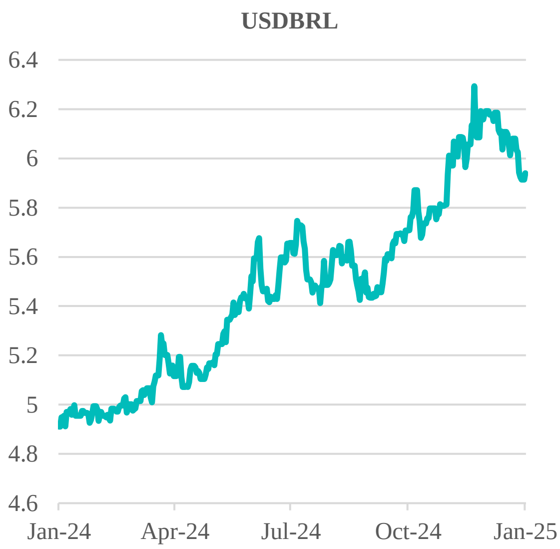
Aurora Macro Strategies – Brazil Report: A Very Real Reckoning, January 31, 2025

The Tearsheet

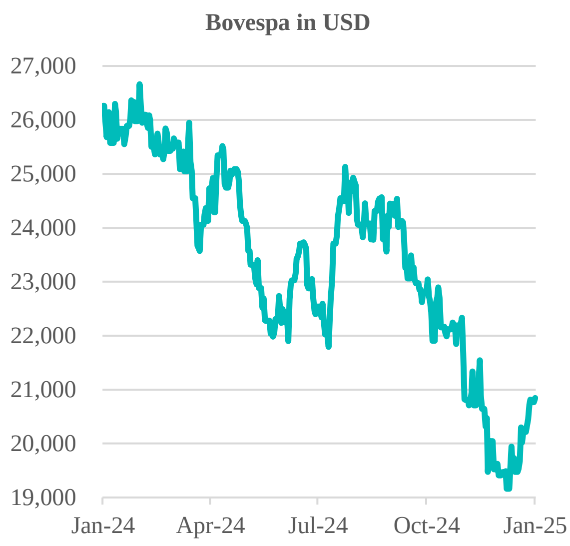
- Brazil's growth exceeded expectations in 2024. However, tighter monetary policy, while curbing inflation, is likely to slow growth and could lead to a mild contraction by year-end.
- Increased government spending under Lula has pushed the fiscal deficit above 8% of GDP. The less ambitious adjustment plans disappointed markets, triggering a sharp sell-off in the Real.
- Brazil's rising debt burden has diminished the appeal of its financial assets among international investors. Portfolio outflows were negative in both 2023 and 2024, prompting heavy intervention by the Central Bank to defend the Real in late 2024, reducing dollar reserves by 11%.
- The current account deficit widened in 2024, and Donald Trump's election could create new trade uncertainties. However, agricultural exports remain robust, with record harvests expected in 2025, and direct investment inflows continue to show resilience.
- Amid declining approval ratings, President Luiz Inácio Lula da Silva has begun reshuffling his cabinet, starting with the replacement of the Communications Minister in mid-January. Further changes, likely favoring the government's centrist allies over Lula's Workers' Party (PT), are anticipated in the coming days.

1. The Shadow of Recession

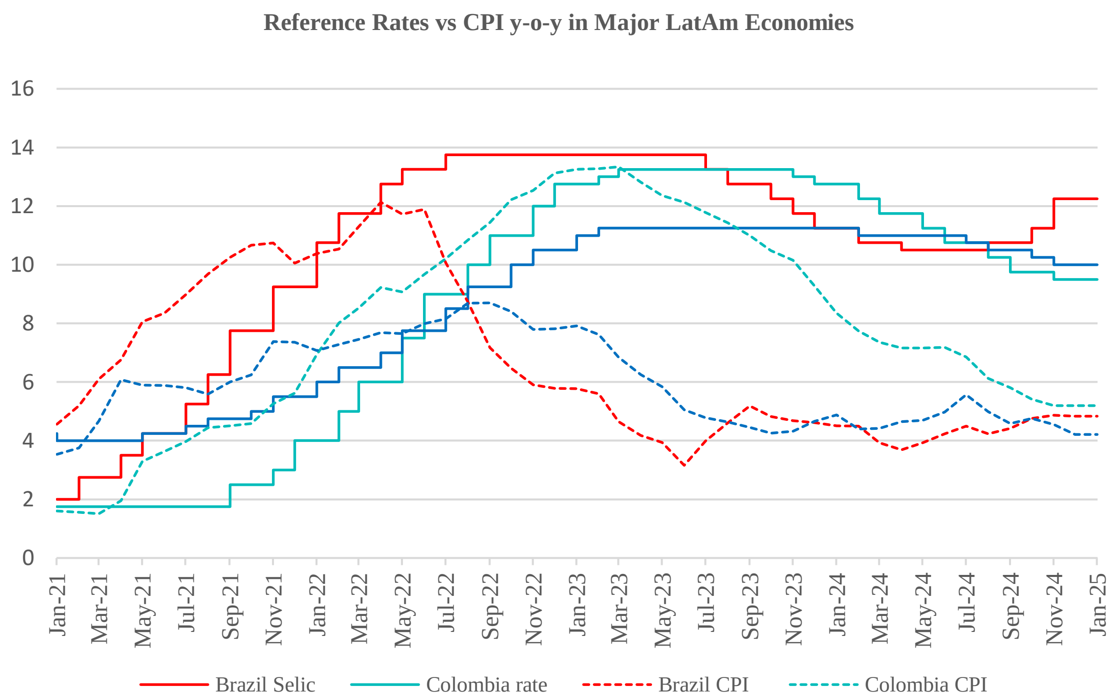


- As he begins the third year of his third term in office, President Luiz Inácio Lula da Silva is under pressure from all sides. The government's popularity ratings have fallen to their lowest level since his 2022 election triumph and business confidence is at a low ebb.
- With monetary policy tightening to control inflation, the economy is expected to slow in the next two years, with some forecasters predicting a mild recession in the second half of the year.
- The delay and dilution of a fiscal adjustment package led to a sharp weakening of the Real, as well as the price of financial assets in December. The Real continues to trade close to BRL 6 to the dollar, even though the Central Bank's monetary policy committee has increased overnight rates to 13.25%, with two 1% increases in both December and January. A further 1% rise is promised at its next meeting in March.

- The decline in the dollar led to extensive Central Bank intervention in the last two months of 2024, resulting in foreign reserves falling by 11.6% from USD 372 billion at the end of September to USD 329 billion by year end, the lowest figure for nearly two years.



- The government was able to meet the terms of the fiscal framework (arcabouço) agreed in 2023, under which the primary deficit must be limited to a maximum of 0.25% of GDP (about BRL 28.8 billion) because the Treasury received some BRL 31 billion in special dividends from state-owned Petrobras and BNDES, as well as some BRL 9 billion in income from the renewal of energy, railway and other concessions. However, investors remain concerned by both the size of the overall deficit and by the scale of growing indebtedness.
- In November, the deficit stood at nearly BRL 1 trillion - roughly 8% of GDP. Gross debt as a percentage of GDP has risen from 71% at the beginning of Lula's third mandate to an end 2024 level of 77.3%. According to some private sector forecasts, net indebtedness is expected to rise by nearly 10 percentage points of GDP by 2028.
- Higher interest rates have fueled concerns about the cost of debt servicing, raising fears in some quarters about so-called fiscal dominance (a situation in which tight monetary policy aggravates fiscal pressures partly by increasing the cost of debt service). In 2024, the government paid 6.7% of GDP in interest, compared to an average of 4.1% between 1997 and 2014 and 5.2% between 2015 and 2019.



2. A Monetary Squeeze

- Brazil's economy grew by 3.8% in the first 11 months of 2024, exceeding the 1.5% expected growth in January 2024 and an increase from a 2.9% expansion in 2023. The most impressive element of the expansion was the decline in unemployment, which reached 6.1% in November, the lowest level since numbers were first published on the current basis in 2012.
- However, growth at this pace appears unsustainable, with the output gap positive since 1Q24 and inflationary pressures re-emerging despite rising interest rates. IPCA breached the 4.5% ceiling of the Central Bank's targeted range throughout 4Q24. A monthly rise in food prices of more than 7.6% was one of the most notable features of the latest readings.
- Tighter monetary policy is now expected to contain inflation at about 5% in 2025 and 4% in 2026 but at the cost of slower growth. The latest consensus private sector forecast projects 2% growth in 2025 and 1.8% in 2026. Indeed, figures from the statistics agency suggest output from services and industry turned negative in November 2024 and retail sales declined on a month-by-month basis.
- Rate rises will increase the cost of credit for Brazilian businesses, many of which are already struggling to service debts. From January to November 2024, 2,085 Brazilian businesses filed for bankruptcy, an increase from 1,303 in 2023 and 756 in 2022 over the same time period, according to Serasa Experian, a credit bureau. 7 million Brazilian companies are currently in default on loans while business confidence fell to 50.1 in December 2024 and 49.1 in January 2025, its lowest level since the beginning of the current Lula mandate, according to the National Industrial Confederation index.

3. Trade and Capital Inflow Pressures

- Compounding this grim picture of rising debt and slowing growth are emerging signs of pressures on Brazil's trade account. Falling prices of big commodity export products, such as iron ore and soya, coupled with a decrease in demand from China, have halted the recent increase in export revenues. Meanwhile, the recent growth in the economy has sucked in more imports, leading to a widening in the current account deficit from $24.5 billion in 2023 to USD 56 billion in 2024.
- Brazil potentially faces additional headwinds in this respect due to Donald Trump's return to the U.S. presidency. During his first term, President Trump imposed tariffs on Brazil's steel and aluminum exports and could do so again, potentially also broadening the range and scale of U.S. protectionist policies. This likelihood will increase particularly if Brazil were seen to be pursuing an anti-U.S. economic agenda by, for example, deepening links with the BRICS group and reducing the use of the dollar in its international transactions.
- In 2024, the U.S. was the third largest destinations for Brazilian exports with total sales of USD 40.3 billion, of which USD 31.6b billion were manufactured goods. Trump's presidency also potentially benefits the right-wing opposition to President Lula's government. President Trump's inauguration was attended by the former President Jair Bolsonaro's wife, Michelle, and his third oldest son, Eduardo, who is a federal senator.
- There is also a possibility, however, that trade tensions between the U.S. and China could benefit Brazil, by increasing Chinese demand for its soya bean and other agricultural exports or spurring European politicians to approve the recently approved EU-Mercosur trade deal. In addition, initial signs that Trump administration action on tariffs was less radical than had

been feared, helped a modest rally in the local currency at the end of January, although the Real remains sharply undervalued compared to its historical average.

- Inflows of portfolio capital also fell sharply in 2024, largely driven by continued nervousness about public spending and debt as exemplified by investment banks, such as JP Morgan, Morgan Stanley, and HSBC, lowering recommendations to underweight. Brazil now accounts for just 4% of the Morgan Stanley emerging market index, compared to 5.8% at the end of 2023 and a peak of 17%.
- In a recent report for investors, one bank drew a direct comparison between the current Lula administration and the disastrous second government of Dilma Rousseff between 2015 and 2016, which culminated in a deep recession and the then-president's impeachment and ejection from office. However, Aurora holds the Rousseff comparison to be unhelpful. In 2015, current account deficit amounted to 3.5% of GDP and the currency was overvalued. Whereas Central Bank presidents were under direct political pressure during the Rousseff administration, Central Bank autonomy introduced in 2021 ensures the current incumbent Gabriel Galípolo - who took over in January - has a much greater degree of independence.
- Another saving grace has been the continued strong performance of direct foreign investment, which reached an estimated USD 70 billion in 2024, up from USD 62.4 billion in 2023. Our sources are particularly confident about continued growth in Brazil’s motor sector, where European, U.S., and Asian companies have pledged BRL 100 billion in developing capacity, mainly in the electric and hybrid vehicle category, over the next four years.

4. Lula Looks to Recast and Reset

- With the next presidential elections scheduled for October 2026, the governing Workers’ Party (PT) aimed to bolster its support in the October 2024 municipal elections. Although it improved on its 2020 performance, the party only managed to become the ninth-largest political force.
- The elections underscored the growing influence of the Centrão, a coalition of self-interested centrist and center-right parties that already dominate Congress. Among them, the Social Democrat Party (PSD), led by former São Paulo mayor Gilberto Kassab, performed particularly well. The PSD, which already holds three ministerial positions, is now well-positioned to expand its cabinet presence at the expense of the PT and its left-wing allies.
- Kassab’s criticism of the administration on January 29 has fueled speculation that Lula may increasingly rely on support from two other Centrão parties: the Republicanos (affiliated with the influential Pentecostal Universal Church of the Kingdom of God and the incoming lower house president, Hugo Motta) and the Progressive Party, led by former lower house president Arthur Lira. However, these alignments are expected to remain fluid.
- The only major cabinet change announced so far is the appointment of Sidônio Palmeira, a discreet and pragmatic publicist from Bahia who managed Lula’s successful 2022 campaign, as Minister of Communications on January 14. He replaced Paulo Pimenta. Palmeira’s first move was to dismiss two social media specialists who had been part of a team overseen by Lula’s wife, Rosângela da Silva, known as Janja. Janja had come under fire for her confrontational remarks toward Elon Musk, who will be part of the Trump administration, and for her ineffective efforts to promote PT’s female candidates in the municipal elections.

- Recent polling highlights the scale of the challenges facing Palmeira. A January survey by Quaest found that 47% of respondents approved of Lula’s performance, down from 52% in December—the lowest level since he took office in January 2023. Disapproval rose to 49% from 47% the previous month. The decline was particularly pronounced in Lula’s stronghold, the Northeast, where positive assessments fell from 69% to 59%.
- A controversy surrounding Treasury plans to more closely monitor the popular Pix payment system may have contributed to the dip in Lula’s approval. Right-wing figures close to former President Jair Bolsonaro falsely claimed that the government intended to impose taxes on these transfers.
- Rising food prices are another factor weighing on the government’s standing. In 2024, food prices surged by 41.4% in local currency and 13.49% in dollar terms, according to the central bank’s IC-Br index, which tracks the impact of commodities on domestic prices.
- Despite declining approval for both himself and his government, Lula remains the frontrunner for the 2026 election. His main rival, former President Jair Bolsonaro, has been barred by the electoral court from running until 2030. Bolsonaro also faces legal proceedings related to his alleged involvement in the January 2023 coup attempt and other irregularities.

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