

INTRODUCTION

Following a tumultuous and divisive race which saw two polarizing rivals on opposite sides of the political spectrum go head-to-head, the Brazilian people elected a new president on October 30, 2022. Former President Luiz Inácio Lula da Silva (commonly known as Lula) of the left-wing Workers' Party (PT) claimed victory in Brazil's election by a narrow margin, with just 50.9% of the vote. Lula's opponent, right-wing incumbent President Jair Bolsonaro of the conservative Liberal Party (PL), remained silent for several days before conceding, indicating that the presidential race was over.

With the political fate of Latin America's largest economy decided for the next four years, we spoke to local specialist Florian Bartunek to understand the implications of these elections results for Brazilian democracy, the economy and equity markets. Florian is the founding partner and CIO of Constellation. Founded in 1998 and based in São Paulo, Constellation is one of Brazil's longest standing and most experienced equity shops. The ABS team has known Florian and his team since the inception of ABS and has been investors since 2004.

-Natascha B. E. Willans, Partner and Analyst at ABS Global Investments

LOCAL VIEWS: AN INTERVIEW WITH CONSTELLATION CIO, FLORIAN BARTUNEK

The 2022 Presidential election was very tight, underscoring the country's sharp political polarization. Lula narrowly won the election with 50.9% of votes, while Bolsonaro held 49.1% of the population's support. What do the election results mean for Brazil's democracy?

The results were very positive. Especially, the aftermath of the results. The voting system worked perfectly. In my view, Brazil is at the forefront of technology and voting systems. Approximately three and a half hours after the polls closed, we already had an election result. Some hours later, the speaker of the House, the president of the Senate, and even some right-wing politicians were already accepting Lula's election victory. The next day, some supreme court justices and more politicians recognized the election results. And finally, just two days after the polls were closed, Bolsonaro started the transition process. Indeed, the transition is already happening, with both teams meeting to discuss a number of matters, the most significant of which is the budget.

This smooth election aftermath was a relief as there was a material risk of some disturbance once results were announced. Some people even questioned if we could see an event like we saw in the United States on January 6, 2021. While there are some isolated protests, the scale is very small. The most notable were movements by Brazilian truckers protesting Bolsonaro's loss and blocking roads on the first day after the elections. Now, there are no blockades anymore and its business usual. In fact, in just over a week, people are going to start to worry more about the Soccer World Cup than politics. So, at the end of the day, I see this election as a victory for democracy. The election process was orderly, the transition of power has started, and there has been no major disruption coming from either the far-right supporters or from the military.

The first round of elections on October 5 delivered strong results for allies of President Jair Bolsonaro, giving his party the most seats in both chambers of Congress. What are the implications of the country having a right-leaning Congress with a left leaning president? What are the implications for domestic policy?

The direction of voter sentiment on key topics, such as the economy, is very important in Brazil. The stigma and sentiment towards a more open, pro-market economy has changed significantly in the last two decades. Twenty years ago, privatization was a bad word. Now most people in Brazil think the country needs efficient public services and efficient companies, and less state-owned enterprises. The winds are blowing in favor of a more pro-market, open economy in Brazil. There is no communist, socialist wind blowing here. Quite the opposite. Politicians have responded to this shift in perception by increasingly positioning themselves towards voter sentiment and its pro-market, open economy bias. The direct impact of this change is perhaps most clearly seen within Brazil's congress.

Having a more right-wing congress provides “checks and balances” for Lula and the PT party's macro policies. Overall, this is good news. In addition, the political system has several constraints in terms of the fiscal accounts, fiscal balance, and laws which also limit the government's ability to pursue radical projects. On the other hand, Lula is a master negotiator. In fact, he is probably the best politician in terms of negotiating skills in Brazil. He is also one of the most experienced politicians, and as such, he is already forming a support base within Congress. It would not be impossible to see his support in Congress become even stronger than Bolsonaro's.

In conclusion, it is good news that we have a center right Congress. It is good news that we have a master negotiator in the administration. I am pretty confident that we will see policies that make economic sense moving forward. And as for policies that do not make economic sense, they will have a hard time getting appropriate approvals to move forward.

What does a Lula government mean for the overall Brazilian economic outlook?

There is no doubt that Lula will have a social bias in his government. Not socialist, but social bias. He strongly believes in markets, but also inclusive economic policy and will aim to foster a more equitable economy. But there are constraints to how far this can go. Recent events in the UK have demonstrated that markets are scrutinizing fiscal policies and the impact they can have on net debt to GDP ratio. Both Lula and the transition team are very much aware of this. As a result, we expect that the economic policies coming from Lula's new government will be centrist and balanced, rather than leftist with the intention of reducing inequality or improving the lives of the poorest.

GDP Growth

In terms of the economy, we are optimistic. Brazil delivered strong economic growth last year and 2022 should see GDP grow approximately 3%. Economic growth for next year is still uncertain and will depend on how fiscally responsible the new government is going to be. So far, all early indicators point to a fiscally conservative government ahead. There are billions of dollars already contracted in infrastructure and foreign direct investments. We should have a decent economy going forward if Lula does not make any big mistakes.

Monetary Policy

Interest rates are expected to come down in 2023, but the timing will again depend on the degree of Lula's fiscal responsibility. If he starts his term being very fiscally conservative, interest rates will fall much faster. If he, on the other hand, tries to spend large sums on social programs with little regard to the government accounts, Brazil will have higher interest rates for longer. As a reminder, Brazil has an independent central bank, whose president will be in power for two more years. In the unlikely event that Lula goes down a fiscally irresponsible path, the central bank will react accordingly.

Reforms

We do not expect any major pro-market reforms ahead. Instead, we expect a flurry of micro reforms, aimed at improving the business environment. That is exactly what Lula did in his first government. Finally, we also need to remember that even during the last PT party governments we had the sale of road concessions and airports being privatized.

How have equity markets reacted to Lula's victory? Looking forward, what does a Lula government mean for equity markets?

First Reaction

The first reaction of equity markets to a Lula government was positive. The market rallied +8.2% in the week following the elections. Why the positive reaction? First, there was no material post-election disruption. Second, Lula's post-election speeches and the lack of far-left rhetoric were positively received by investors. In addition, nominations for the transition team and key economic posts have thus far been encouraging. While the Minister of the Economy is yet to be announced, key advisors are already known and are both very sophisticated pro-market economists with backgrounds in a large and relevant investment bank in Brazil. Thus far, Lula and his team are doing a good job not creating any market noise.

Fiscal Responsibility

Our base case is that Lula's government will be more fiscally responsible than expected. This is going to be very good for markets. Indeed, it makes much more logical sense to be fiscally responsible in the first two or three years of a mandate, leaving room to be



more lenient on the fourth year as the incumbent ramps up for a new election. Leniency would help a president to get reelected or, in Lula's case, probably elect his successor.

Foreign Flows

International investment flows into Brazil should provide tailwinds for equity markets. Foreign investors generally tend to see Lula more positively than President Bolsonaro. This should lead to a better relationship with the United States and some key European countries. The fact that environmental issues seem to be on the top of Lula agenda should further support these relationships. Indeed, Lula spent a large portion of his victory speech talking about the Amazon Forest. With a Lula government in sight, some European countries have started to recommit to the Amazon fund, which they walked away from under a Bolsonaro government. There is potentially much more money to come in than to get out of equity in Brazil.

Lower Rates

While politics is important, the main driver for equity market performance in the coming year is going to be falling interest rates. In this regard, Brazil is ahead of the curve. It was the first country to raise rates in March of 2021 and we believe Brazil will be the first country to lower rates. GDP growth and inflation in Brazil is lower than in other countries.

Earnings

At the end of the day, equity prices are driven by earnings, and we are bullish on earnings. Companies in Brazil are now in much better shape than they were ten or twenty years ago.

In conclusion, the outlook ahead for Brazil looks very good: a better economy, a better international perspective, and a very positive technical position with both foreign and local investors underweight equities.

How does this election outcome impact Brazil's role in the world?

Our perception is that foreigners prefer Lula over Bolsonaro as they perceive him as much more reliable and reasonable. Bolsonaro has a very right-wing view regarding issues such as foreign relations, the environment, and foreign trade. Lula is a much more centered and reasonable leader with regards to those issues. In his victory speech, Lula spent a lot of time on environment. The result is that we are already seeing European countries and the US congratulating Lula as they say "now we are open to do business with Brazil again and we're open to send money or funds to help conserve the Amazon."

When we talk to European, Canadian, and American investors, we get the sense that the Lula victory was a relief. We expect that we are going to see foreign inflows, not only in terms of foreign direct investments or in real assets, but also inflows from endowment and pension plans.

What investment opportunities do you see arising from these events for your portfolio? Are there any risks that have been magnified?

We believe that Brazilian companies with a domestic orientation will generally benefit from Lula's presidency. First, if Lula is reasonable from a fiscal standpoint, interest rates will fall sooner which will be good across all sectors. We should know more about this over the coming few days as the government budget is already being discussed by the transition team.

Assuming a fiscally reasonable Lula government, consumer discretionary and consumer staples stocks will benefit. The education sector is also likely to face tailwinds, supported by the expectation that Lula may resume some of the government sponsored scholarship programs from his prior time in office. Lula's victory could also be good for the low-income housing industry. Note that we do not invest in all these sectors, as it is important for us as investors to like the business in addition to the industry in which they operate.

Meanwhile, state-owned companies are facing a more uncertain future. In the past these state-owned companies have been used as government arms to induce growth or other public policies. While we attribute a low likelihood of such events given state-owned company's law, the months ahead are likely less exciting for these businesses.

More importantly, we believe that a non-disruptive Lula government with economic growth will be good for leading high-quality businesses in Brazil. For a long time, we have subscribed to the thesis that these types of companies have huge competitive advantages which allow them to keep growing, gaining market share and increasing efficiency. A reasonable Lula government with lower interest rates sooner would be a big plus for quality and growth companies.



Finally, the recent market environment has been very challenging for active management in Brazil. Lula's victory could change the fortunes for active management as local businesses and growth companies face tailwinds and index-heavy-weight state-owned businesses face a more uncertain future.

SOME FINAL THOUGHTS

Investors in Latin America often feel that region is marked by a steady stream of elections and political events, each with the possibility of changing the direction of its underlying country's policies and economies. The recent presidential elections have shown us that Brazil is no exception. As Florian described, the recent election results have implications that may shape the Brazilian economy and equity markets as well as define their winners and losers over the coming years. A deep understanding of this backdrop and its intricacies is critical for investors to assess the investment opportunities and risks that will inevitably arise. We believe that local specialists possess a deep and unique knowledge of these events and their implications for businesses. Armed with this knowledge, we believe that local specialists are best placed to navigate these markets and generate alpha for investors.

BIOGRAPHY: FLORIAN BARTUNEK

Florian Bartunek is the founding partner and CIO of Constellation. Florian founded Constellation in 1998 as Utor Investments, a proprietary fund for the founders of 3G. Prior to founding Constellation, Florian was a partner at Banco Pactual where he was head of research, proprietary trader, and manager of all equity portfolios/funds including a segregated portfolio for George Soros. Florian earned a B.S. in Business at Pontificia Universidade Católica – PUC Rio (1990). He graduated from Harvard's YPO President's Program (2010 – 2021), Advanced Value Investing at Columbia Business School (2021), CEO Harvard Business School Program (2021), Bruce Greenwald's Value Investing Course (2013) at Columbia Business School, Disruptive Innovation (2020) at Harvard Business School, Singularity University Executive Program (2015), Sustainable Business Strategy at Harvard Business School and the Behavioral Finance program at Harvard Kennedy School (2016). Florian was a professor of a Value Investing course at INSPER University in São Paulo, president of the Paulista Chapter of YPO – Young Presidents Organization and Director of the International Department for the Brazilian Investment Banking Association – ANBID. Florian participates in the boards of Fundação Estudar, Fundação Lemann, Instituto PROA, B3, Fundação St. Paul's and Associação Nova Escola. He has also participated in the boards of the Museum of Art of São Paulo – MASP and Somos Educação.

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