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Daily Commentary

Brazil, an Unexpected Victory

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It was supposed to be a formality.
In the first round on October 4, Flávio Bolsonaro had come out ahead of Lula with **47**% against **45**%.
The latest polls still had him in the lead, and the betting markets gave him roughly an **80**% probability of victory.
On Sunday evening, however, **the electoral court proclaimed Lula the winner with 51.8% against 48.2%**.
Since the return of democracy in 1989, no candidate who finished second in the first round had ever managed to overturn the result in the runoff.
Adding to the complexity is the way the day ended.
A few minutes before the polls closed, a Supreme Court justice, at Lula's own request, extended the voting by two hours because of disruptions in public transport, when some polling stations had already closed.
Bolsonaro is now demanding that the elections be annulled.
The market is therefore having to deal with two surprises at once, an unexpected result and a period of political uncertainty of unknown duration.

Why does the reaction risk being violent?

Not so much because of Lula himself, but because investors had already bet everything on the opposite outcome.
The day after the first round, the São Paulo stock exchange rose by **7.7**%, the strongest increase since 2020, and foreign investors bought Brazilian shares for over **10** billion reais in a single session.
The so-called "Bolsonaro trade", the bet on a government more attentive to public

Source: Bloomberg, Reuters, Yahoo Finance, Financial Times, ECB, CNBC, The White House
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finances, had become the most crowded theme of all the emerging markets.

On the eve of the vote, Brazil was more than **15**% above its own 200-day moving average (the average price of the last ten months; when a market moves far away from it, it means it has risen quickly and that many have entered late), more than any other stock market in the world, with a gain of **36**% in dollars since the beginning of the year.
The real was the currency that had appreciated the most against the dollar.
The risk of a Lula victory was known.
In a survey by a major American bank, **80**% of investors expected a decline of more than **5.0**% in that scenario.
The only problem is that it was assigned a **20**% probability.

More than a black swan, a gray swan.
Everyone could see it and few had protected themselves against it.

The night gave the measure of the shock.
On the markets open over the weekend, the future on the real lost **9.1**%, bringing the implied exchange rate to around **5.51** reais per dollar from 4.98 on Friday.
The American ETF on Brazilian shares fell by **18**%, the one listed in Tokyo by up to **16**%, Petrobras lost **11**-**12**%, and Nu Holdings, the Brazilian digital bank listed in New York, over **12**%.
These are prices recorded on thin volumes, but the direction is clear.

The real test comes at 2 p.m. Italian time, with the opening of São Paulo.
In Brazil there is a circuit breaker, an

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automatic switch that suspends trading for 30 minutes if the index loses 10% and for one hour if it reaches 15%.
In the entire history of the Brazilian stock exchange it has been triggered **17** times, the last time in March 2020.
Today several local operators consider it likely.
Bonds are also under pressure.
The most severe scenario of a leading American investment bank foresees long-term yields rising by **200** basis points, that is, by two full percentage points.
Brazil has little room for maneuver.
Public debt is at **82.9**% of GDP and interest spending alone is worth almost **9**% of GDP.
To stabilize the debt, a correction of the public accounts of about **3.5** points of GDP would be needed, and Lula promises an adjustment without yet explaining how.
In addition, about half of the federal debt is linked to the official rate, that is, every rate increase immediately turns into new interest spending.

So far, Brazil.
Why should it also matter to those who have not invested directly in Brazil?
The answer lies in three letters: **VaR**, Value at Risk, that is, the maximum loss a portfolio can suffer over a certain period with a given probability.
It is the thermometer with which pension funds, insurance companies, asset managers and banks measure risk, and each has a limit not to be exceeded.
VaR depends on two things: how much one owns and how much what one owns fluctuates.
If the volatility of an investment doubles,

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the same position "consumes" twice the permitted risk.
At that point there is only one way to get back within the limit: sell, not because one has changed one's mind about Brazil, but because the model requires it.
It is the same mechanism of forced selling that last Thursday hit hedge funds on the technology front and today risks repeating itself on emerging markets.

Who has to sell?
Those who were overweight: global emerging market funds, for which Brazil had become the favorite bet, funds dedicated to Latin America, and portfolios that used the real as a carry trade, that is, they borrowed in dollars or euros to invest in reais and collect double-digit rates.

Those who sell out of obligation sell what is liquid, not what they would like to sell.
During the night the Mexican peso led the declines among emerging market currencies, and emerging markets as a whole had raised **33.5** billion dollars in the last four weeks.
More money that came in quickly means more money ready to go out.

Now let's look at the effects on European and American portfolios.
When São Paulo is closed or illiquid, those who have to reduce their exposure to Brazil sell what they can find: companies listed in Milan, Madrid or New York that derive a significant part of their profits from Brazil.
In **Italy** the most exposed name is TIM, which obtains almost a third of its

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revenues and almost half of its EBITDA (gross operating margin) from its Brazilian subsidiary.
Next come Enel, with over **2** billion dollars of EBITDA generated by Enel Brasil, and Stellantis, the country's leading car manufacturer with almost **30**% of the market.
In **Spain** the list is long: Santander (about **15**% of profit from Brazil), Mapfre (almost a quarter), Telefónica with its subsidiary Vivo, and Iberdrola with Neoenergia.
In **New York**, the exposed names are MercadoLibre (for which Brazil is the first market), Nu Holdings, StoneCo, PagSeguro, XP and Mosaic (about 40% of sales).

There are two transmission channels: **the conversion of profits** (a weaker real is worth fewer euros and fewer dollars) and the **real economy**, with higher rates and households that are already heavily indebted, with defaults on personal loans at their highest in twenty years.
Not everyone suffers in the same way.
Those who sell oil in dollars, like Galp or Petrobras, are less affected by the exchange rate, and Brazilian exporters can even benefit from a weak real.
The heaviest bill is paid by banks, insurance companies, telecommunications and consumer companies, that is, those who earn and spend in reais.

Should we despair?
No, because with the real between **5.40** and **5.50**, the yield on offer becomes very interesting again and, according to some

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currency traders, that is precisely where the move could run out of steam, when high rates start attracting buyers again.
Lula will have to govern with a Congress in which the right carries great weight and which can curb spending drifts, while his relations with Trump are more relaxed than the election campaign led one to believe.
Those who remember 2002 know that the Lula of the "Letter to the Brazilian People" was able to reassure the markets.
However, **to regain confidence, names and numbers will be needed, starting with the finance minister and the 2027 budget law.**
Until then, on portfolios, risk models will count more than fundamentals.
A day of selling on Brazil-linked stocks awaits us, with TIM, Santander and Mapfre under pressure already at the open and an afternoon in which São Paulo will set the pace for all emerging markets.

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