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The Impact of Record Low Interest Rates in Brazilian Capital Markets

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Abstract

At a time in which most countries have been experiencing low to negative interest rates, Brazil is just now joining the global trend. The Selic rate (equivalent to the Fed Funds Rate) is the key tool for monitoring monetary policy by the Brazilian Central Bank (BCB). With recent cuts, the Selic has landed in 4.25%, a rate never experienced before in the Brazilian economy (Brazilian Central Bank, n.d.). This paper seeks to analyze the impact of record low interest rates in the Brazilian capital markets. The paper approaches the impacts of low interest rates from the perspective of individual investors and Brazilian public traded companies.

Acknowledgements

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Introduction

The history of high interest rates, which is determined by the Monetary Policy Committee and known as the Selic rate (Brazilian Federal Funds rate) (See figure 1), in Brazil goes back to the early 1960's. The country was run by a military dictatorship, and it was marked by political turmoil, social repression, and economic instability. More specifically, in March of 1964 the military regime, supported by the U.S. government, took control over the Brazilian government (Barrucho, 2018). Known as the "Military Blow," this dictatorship movement sought to restore economic and political order both of which were being perceived with communist characteristics by the previous government. The military indeed accomplished its goal of improving the economy, which in 1973 had a GDP growth of 14% pushed by government spending on infrastructure, electric power generation, and industrialization (Barrucho, 2018). The military dictators used the slogan "50 years in 5" to market their excellent economic expansion. However, their spending has left significant wounds to the Brazilian economy which at the time was being mainly financed by international creditors. In other words, the Brazilian foreign debt went from $5.98 billion in 1970 to $104.17 billion in 1984 (Barrucho, 2018). In addition, inflation also got out of control rising to over 2000% in the following years after the military officials stepped down (World Bank, 2019).

It took the following governments many different approaches (monetary and fiscal) to address the situation which in the end resulted in an inheritance of high interest rates and an uncontrolled fight against inflation. Since 2010 inflation had been above the 5% average target inflation rate of the Brazilian Central Bank (Brazilian Central Bank, n.d.) (See Figure 3). Besides inflation and a past filled with irresponsible government spending, Brazil's political turmoil and economic instability culminated to the downgrading of its creditworthiness to the junk category in 2015 by the Standard and Poor's. At the time, the country faced a severe recession with the economy expected to shrink by 3% before returning to modest growth in 2017 (Wharton University of Pennyslvania , 2015). In addition, inefficient court systems with precarious laws to protect creditors have also contributed to the history of high interest rates relatively to other countries.

This fight to control high inflation finally came to an end in 2017, when inflation got below its target rate and has remained under the BCB's control. This has been one of the reasons for gradual cuts in interest rates (not necessarily in a constant decrease but rather on rollercoaster down trend) which have gone from 20% in 2005 to 4.5% as of February of 2020 (Brazilian Central Bank, n.d.) (See figure 2). Moreover, recently approved social security reforms have also created a better economic environment to allow for interest rates deductions. These reductions haven't only been encouraging the Brazilian economic growth, but they have also been reshaping the Brazilian capital markets.

The impact on individual investors

Before addressing the impact of record low interest rates in the individual Brazilian investor, it is important to acknowledge that 57% of the population does not invest at all (The Brazilian Report, 2018). The reasons for more than half of the population not investing ranges from poor financial education and lack of budgeting to difficult in accessing investment vehicles and information as an individual investor. Those who opt in to invest, however, take a very conservative risk return approach. Savings accounts whose yields are determined by the Selic rate, followed by owning real estate have been the main investment securities for the Brazilian investor (Anbima, 2018). Savings accounts in Brazil are a monthly investment product in which yields are based on interest rates. For instance, in 2012 when the Selic was about 8% to 9%, savings accounts yielded about 6.5% (tax free) per year. That is a fixed 0.5% monthly plus a certain "monetary correction" as a protection against inflation (Nóbrega, 2012).

Given these circumstances combined with economic recessions and several political scandals, investors have been used to earn a steady, safe returns by having their money in savings accounts and certificate of deposits. Based on a survey with 2000 people from Legg Mason and Cicero group, both American investment and business management groups, the top three factors for negative effect on investments progress in Brazil as of 2018 were political and economic instability followed by inflation (Legg Mason; Cicero Group, 2018). Fear as well as the lack of trust in its own politics and economics are also obstacles that Brazilian investors find when it comes to investing. According to another 2018 survey named the X-Ray of Brazilian Investors by Anbima, the Brazilian Financial and Capital Markets Association, 88% out of the 3,400 people surveyed invested in savings accounts while only 5% invested in private securities (Anbima, 2018).

With the recent decline of the Selic to its lowest point in Brazilian history, many investors are not earning the returns they had in the past bearing low risk and volatility. For instance, an investment into a savings account with the Selic at its current rate of 4.25% yields close to 2.98% annually or 0.26% monthly. When adjusting for an expected inflation of 3.4%, investors are not getting the returns they have been used to earn during times of high interest rates (Cutait & D'Avilla, 2020). In fact, savings accounts and other fixed income securities that rely on the Selic for their yield may have a zero to negative return when accounting for inflation. The positive economic scenario with controlled inflation and the slow improvements in the reduction of the unemployment rate (Brazilian Central Bank, n.d.) (See Figure 4) have created a bullish market fueled by record low interest rates in which many new investors are shifting from fixed income investing to equity markets.

Stocks, mutual funds and Fundos Imobiliarios (Fiis) (fundos imobiliarios are like Real Estate Investment Funds or REITS with the basic exception of no debt financing) have been the destination of many new investors. It is arguable that investments in Fiis have been the main type of security of these new investors because of its real estate ballast. In fact, the number of investors in this category went from under 50,000 in 2010 to over 700,000 as of the last October 2019 (B3, 2020). The boom in the number of investors in this particular security goes back to the culture of high interest rates. Other than fixed income investing, many Brazilians also opted to own real estate since the rent income is periodically adjusted to inflation. Therefore, the nature of Fiis make them very similar to real estate investing with the exception that the investors do not directly own a property, but they have shares subjected to market fluctuations that reflect ownership in one or multiple properties. These properties generate rent that is by law required to be distributed in the form of dividends to its shareholders on a monthly or semester basis (Portal do Investidor, n.d.).

The increase in the number of Brazilian individual investors as well as the funds being deposited towards the equity market increases liquidity. In fact, when looking at the Fiis industry alone, the daily average on negotiations has gone up from R$0.021 billion to R$0.332 billion (B3, 2020) (See Figure 5). This boost in liquidity makes it easier for investors to buy or sell securities as well as heat up the real state market whose performance is a key indicator of economic growth. New Fiis are coming up in the market as well as previous ones have been issuing new shares in order to capitalize more funds to acquire assets related to real estate.

As of the last official report from the Brazilian stock Exchange, B3, the numbers of investors went from 85,249 in 2002 to 1,830,745 as of January 2020 (B3, 2020). The more significant increase took place between 2018 and 2019 when the number of total investors went from 813,291 to 1,681,033, resulting in a growth of 48% in the number investors (B3, 2020) (See Figure 6). Meanwhile, the Selic remained at 6% at the same time frame (Brazilian Central Bank, n.d.). Although there might have been a year lag for investors to fly to stock markets, there is a correlation between lowering interest rates and increasing the number of investors.

When analyzing stock market investing worldwide, it is noticeable how Brazil falls behind given the four basic economic resources: land, capital, entrepreneurship, and labor. As of 2018 the Brazilian stock market made up only 1.34% or $0.92 trillion of all market capitalization around the world (The World Bank, 2018). When comparing to the United States, which represents 44.33% of the total market capitalization, an individual company like Apple has recently had its market value over $1.0 trillion (Kolakowski, 2020). That means one American public traded company is greater than all the public traded Brazilian companies combined.

The Brazilian equity market is still a toddler in the middle of grown up adults when comparing to countries like U.S. and China from a capitalization perspective but mainly from a per capita analysis. Brazil ranks 5th in the world largest population with over 200 million (Statista, 2019). When factoring in the number of current investors, it comes to be less than 2% of the population investing on the Brazilian equity market which is way below other countries such as United States with 55% of Americans owning stocks as of April of 2019 (Saad, 2019). Consequently, Brazil still has a lot of potential to grow its investors as interest rates remain at this record low level or continue to decline. This increase of equity-based investments shows how investors are willing to take more risk aiming higher returns instead of keeping their money in fixed income securities that under current rates are barely yielding any returns.

In addition, people who opt in to invest into the stock markets have better chances of not relying only in government pension plans like Social Security. Differing from the United States system in which employers usually offer retirements plans mainly through 401k's, the Brazilian retirement system does not have a vehicle that promotes individual retirement planning and consequently incentivizes investments in the stock market.

The impact on local Brazilian companies

Record low interest rates tends to push companies to use more of debt financing. It becomes cheaper to borrow funds to finance investments activities. When the Selic was at its highest at a rate of 14.25% between 2016 and 2017, the cost of outstanding loans according to the BCB was about 22.98% (Brazilian Central Bank, n.d.). Consequently, for many years Brazilian companies have either avoided financial leverage or they have gone to foreign creditors to take advantage of lower rates even if that implied exposure to currency exchange rates. The largest producer of iron ore and second-largest producer of nickel, Vale SA, looked to the U.S. dollar debt market in 2010 when $1.0 billion of additional capital was needed to finance its rapid growth (Bruner, Eades, & Schill, 2018). At the time the Selic was around 10% (Brazilian Central Bank, n.d.) while the American Federal Fund rate was 0.25% (Loesche , 2018). In other words, Vale decided to issue bonds in American dollars given the high cost of borrowing in Brazil and consequently lower yields for its debt instruments.

As opposing to what Vale did to raise debt financing capital, many Brazilian companies are now taking advantages of lower rates to issue bonds in their home market. Lucianna Lorenzo, the head of international and local debt capital markets at JPMorgan in Brazil states, "the local bond market in Brazil will continue to grow as record-low interest rates push investors to diversify and search for opportunities in local corporate debt". Based on data compiled by Bloomberg, the local bond issuance has increased 8% in 2019 reaching its peak of R$119 billion or $29.3 billion (Gonzalez, 2019). JPMorgan has decided to compete against the local Brazilian biggest banks such as Bradesco SA and Itaú BBA in order to capture some of this growth in the bond market.

When analyzing the composition of the Brazilian stock market, there are critics that the market is too concentrated into commodities, large banks, consumer goods, and telecommunications. "High growth tech companies only find a large pool of investors in the United States," said Tiago Isaac who is responsible to the relations with issuers at the Brazilian only stock Exchange known as B3 (Bautzer & Mandl, 2018). For instance, fintech companies such as the credit card services Pague Seguro Digital Ltd and most recently the Brazilian brokerage version of Charles Schawab, Xp Inc. have done their Initial Public Offering (IPOs) in American Exchanges. Their capitalization amounted for $2.6 billion and $1.96 billion respectively with initial offerings (Marques, Lucchesi, Andrade , & Tse, 2019). Although it was more beneficial to both companies to do their listing in American exchanges due to larger investors' demand and consequently larger capitalization, Brazil and its investors in the end would gain a lot more if these companies had their IPOs at home.

Therefore, this wave of new investors to the stock market and its future development are important to companies in Brazil. Their businesses operations, investments, and financing activities are facilitated with established and developed financial markets that can meet their financing gap, allowing funding for all size companies, especially young and fast-growing businesses hungry for capital (Bernstein, Dev, & Lerner, 2018). A strong, liquid market fuels entrepreneurship and drives innovations contributing for Brazil's economic growth and consequently its society welfare.

Conclusion

Brazil is a late mover into the trend of low interest rates as most economies worldwide have been experiencing. For years the country has been trying to heal from wounds of the past while experiencing political turmoil and economic instability which both in a short-term view seems to be getting back on track. The recent Social Security reform, controlled inflation, and decreasing of unemployment rate are picturing a better outlook for Brazil. Recent cuts in interest rates by its Central Bank are expected to boost the economic scenario.

Although there have been other factors that also have contributed to the increase in the number of stock market investors through years, the decrease in interest rates certainly correlates to this growth. Record low rates are changing the Brazilian capital market with a significant increase in the number of investors allocating their capital to equity-based securities and other types of traded debt instruments. Companies are taking more advantage of local debt financing since it has become cheaper to borrow while also enjoying a more liquid and larger market for their shares. Beyond lowering rates by the Central Bank, Brazil's government must work on its reputation and integrity in order to gain the trust of its local investors. Moreover, the Brazilian government must also facilitate the means while creating vehicles to incentivize the individual investor.

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Appendix A

Brazilian Central Bank Economic Statistics

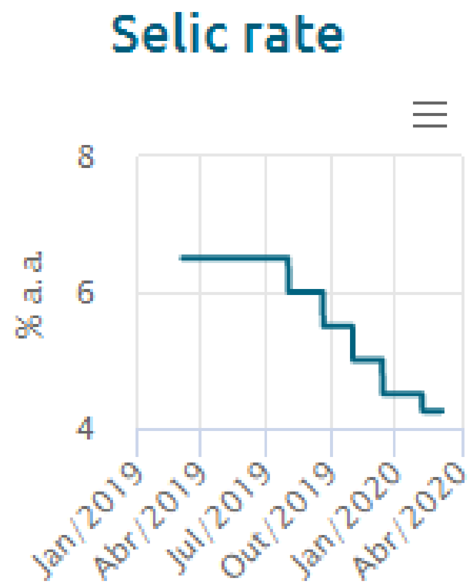

Figure 1. Quarterly Target Rate for Selic

Source: Brazilian Central Bank

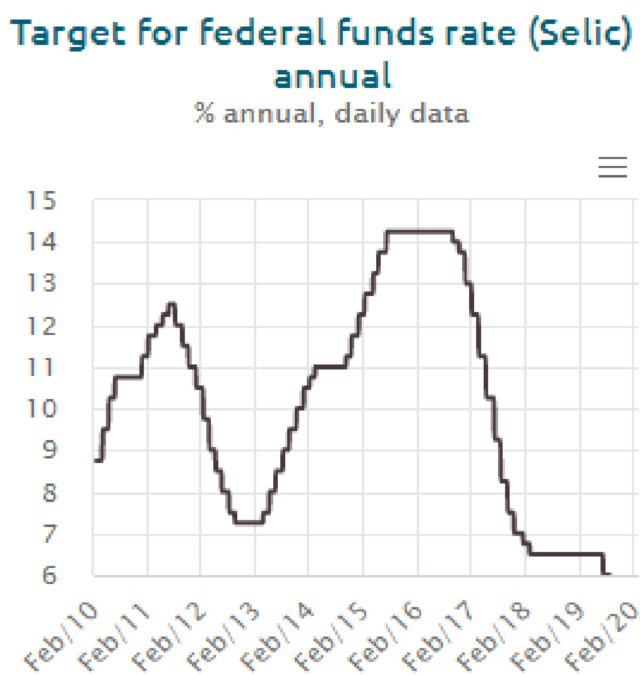

Figure 2. Annually Target Rate for Selic

Source: Brazilian Central Bank

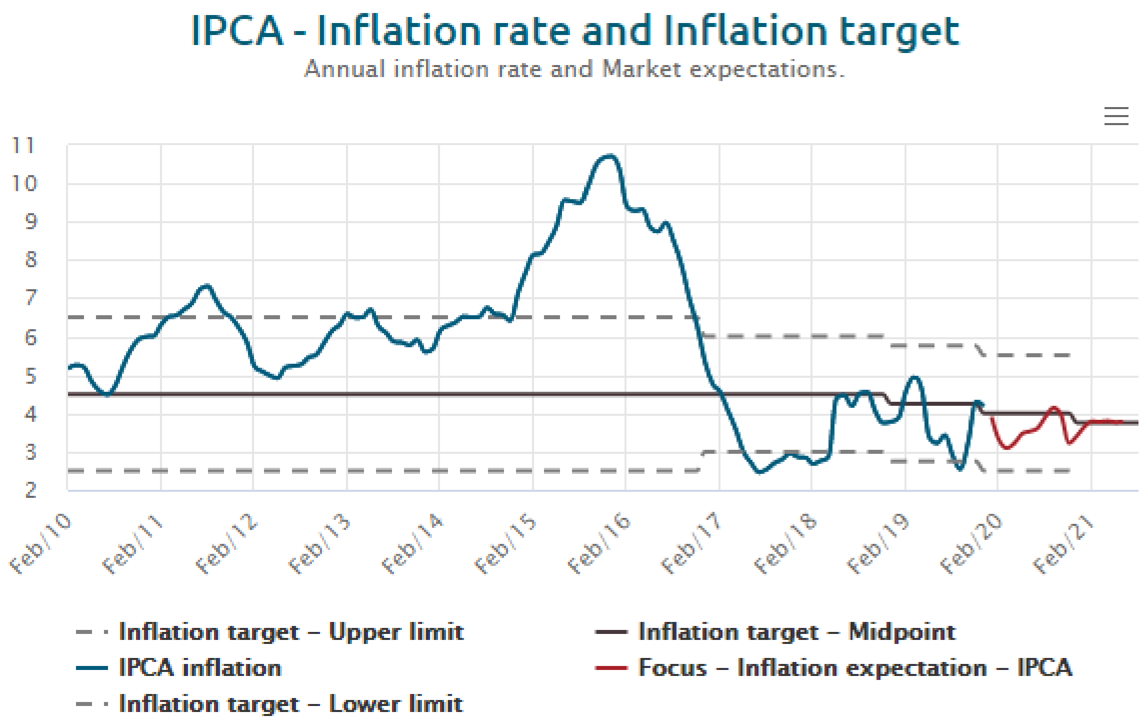

Figure 3. Annual Inflation Rate and Inflation Target

Source: Brazilian Central Bank

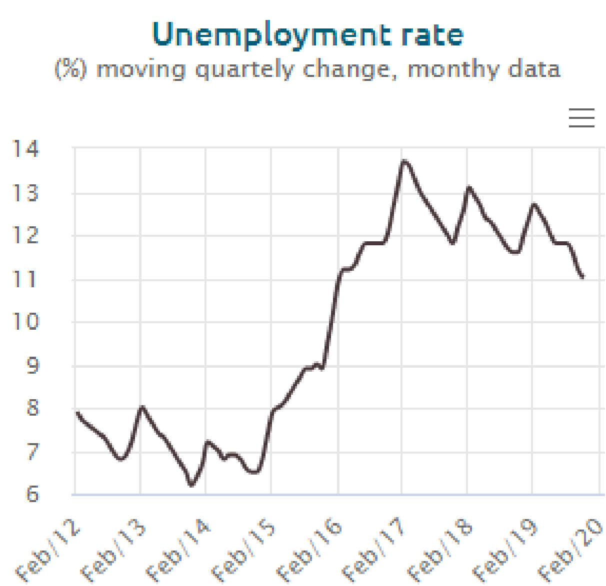

Figure 4. Annually Unemployment Rate

Source: Brazilian Central Bank

Appendix B

Number of Individual Investors by B3

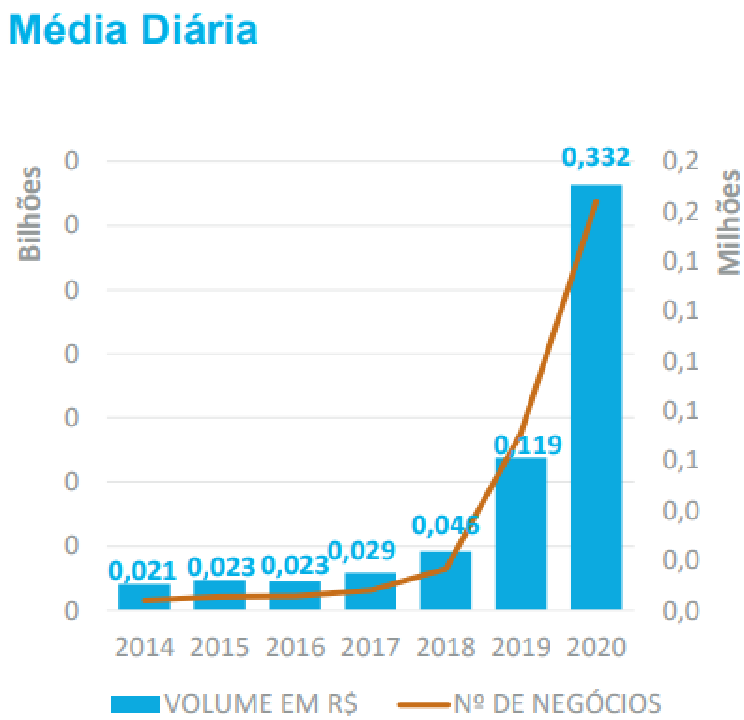

Figure 5: Daily Average of Fiis Negotiated in the Brazilian Stock Exchange

Source: B3 – Brazilian Stock Exchange

Figure 6: Total Number of Brazilian Individual Investors Over Time

Source: B3 – Brazilian Stock Exchange