PGIM FIXED INCOME

Brazil and South Africa: Two Continental Giants with Feet of Clay

PERSPECTIVES | APRIL 2021

FRANCISCO CAMPOS-ORTIZ, PHD
Lead Economist—Latin America, Global Macroeconomic Research

GIANCARLO PERASSO
Lead Economist—Africa and Former Soviet Union, Global Macroeconomic Research

BRIAN LEVINE
Associate, Global Macroeconomic Research

Following heavy public spending during the pandemic, Brazil's and South Africa's government debt has surged over the past year, exacerbating the already sizable fiscal problems both countries were facing before the onset of COVID-19. Moreover, both are now struggling in the aftermath of their largest ever economic slowdowns and contending with slower-than-expected vaccine rollouts. While both countries face significant hurdles in the years ahead and share several common economic features, we believe the outlook for South Africa is more favourable. Accordingly, given its more supportive macro and political backdrop, credible central bank, and deep domestic financing sector, we expect South Africa's local bonds to outperform relative to Brazil's going forward.

Brazil and South Africa are among the largest emerging market (EM) economies and local bond markets for foreign investors.[1] Both economies, however, share the dubious distinction of growing well below the EM complex over the past 15 years. Not only have they underperformed regional peers, albeit by different margins (Figure 1A), but the countries' growth rates had been declining well before the onset of the pandemic (Figure 1B). The two also share several common economic features: both are large commodity exporters, have large public sectors and state-owned enterprises, and their fiscal situations and outlooks have deteriorated markedly. These raise concerns over debt sustainability and the performance of local assets, given that public debt is mostly in local currency (Figure 2).

[1] Brazil's weight in JPM's GBI-EM Global Diversified Index is 8.27% while South Africa's is 7.56%, as of February 2021.

Figure 1A: Average Real GDP Growth, 2005-2020

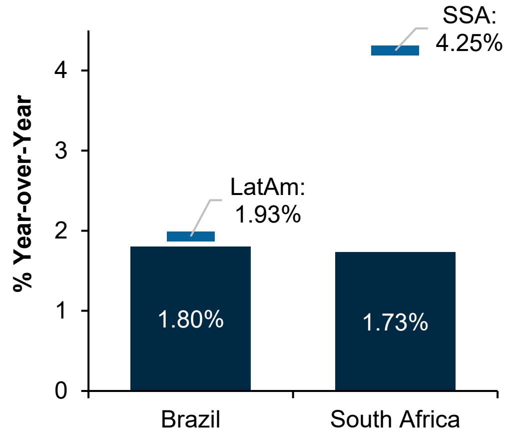
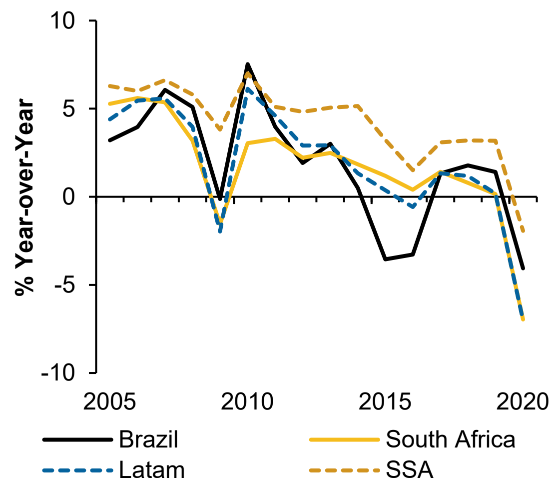
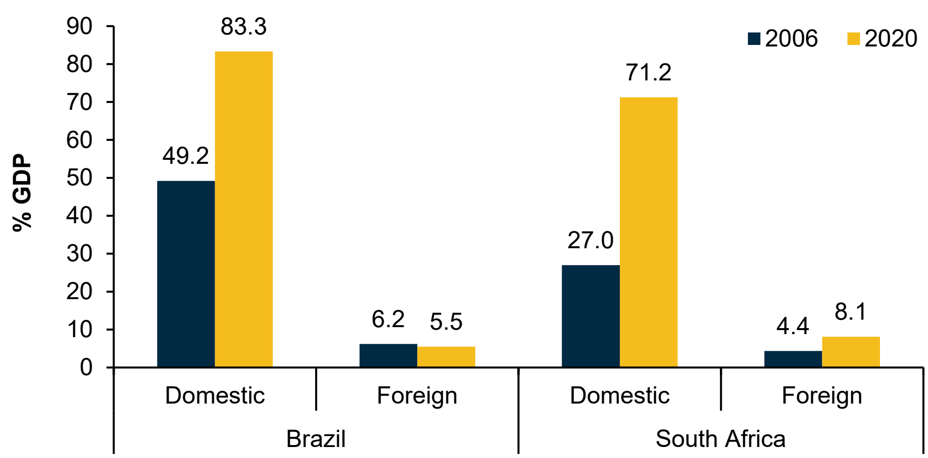


Figure 1B: Real GDP Growth (% Year-over-Year)



Note: The aggregate EM average annual rate of growth was 5%, as of December 2020. Sources: National sources, IMF, Haver, PGIM Fixed Income

Figure 2: Domestic and Foreign Public Debt



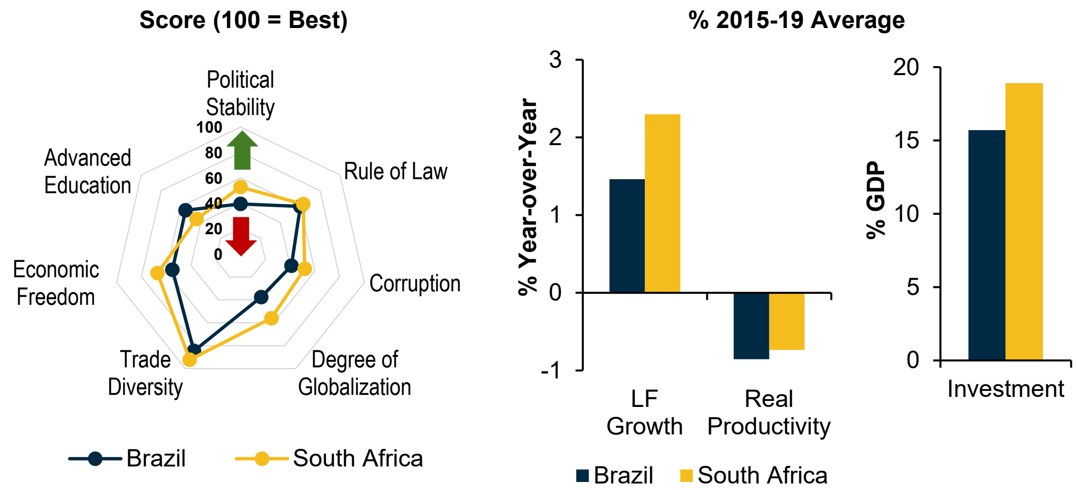
As of December 2020. Sources: National sources, Haver, PGIM Fixed Income.

A Path to Debt Sustainability

To ease their debt burden without resorting to inflationary taxation, Brazil and South Africa need sustained economic growth and fiscal discipline. To assess the former, we examined the structural conditions for self-sustained growth by comparing 28 emerging markets along a range of growth-enhancing structural metrics, including institutional quality, trade openness, human capital, demographics, productivity growth, and investment as a condition to boost future productive capacity (Figure 3). While neither country scored particularly well relative to peers, based on these indicators South Africa is generally better equipped than Brazil to attain a superior growth trajectory.[2]

[2] South Africa and Brazil were also highlighted as highly vulnerable countries in a panel of 25 EMs. See Sheets, N., Hepworth, C., Jiranek, G.; The Prospects of the Emerging Markets – Looking Beyond the storm, July 2020; https://www.pgim.com/pgim-japan/article/pgim-fixed-income-prospects-for-the-emerging-markets

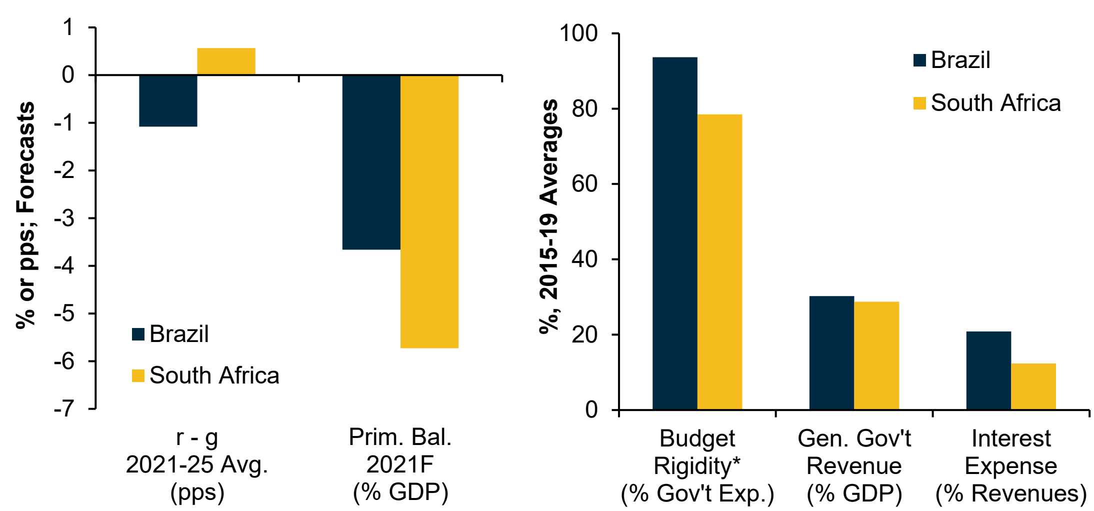
Figure 3: Structural Metrics



As of December 2019. Sources: IMF, national sources, Haver, PGIM Fixed Income.

To analyse the prospects for fiscal correction, we then compared both countries across various metrics capturing debt-sustainability risks and prospects for meaningful fiscal adjustments. The verdict here is mixed. While Brazil starts with a heavier debt burden (88.8% of GDP versus South Africa's 79.3%), its debt-accumulation dynamics are more favourable given the primary fiscal balance forecasted this year and average interest rate-growth differential projected for the next five years. However, Brazil's spending profile is more rigid, with the interest cost taking a larger share of revenues. Both countries have limited leeway to raise revenue.

Figure 4: Fiscal Metrics



* Proxied by total expenditures less capital and other discretionary outlays, as of December 2019. Sources: IMF, IFS, National Sources, Haver, PGIM Fixed Income.

Large Financing Needs in 2021

Addressing growth and fiscal shortcomings in both countries should be part of a multi-year adjustment and reform effort. Of more immediate concern, however, is each country's ability to meet its large financing requirements in 2021. In South Africa, these amount to about $37 billion, or about 10% of GDP, while in Brazil these amount to about $305 billion, or about 22% of GDP.

A fairly large menu of options is available to both countries to meet their financing needs, namely: i) external debt issuance, enabled by both countries' low external debt levels and large reserve buffers, though higher global yields would render this alternative more expensive;[3] ii) limits on foreign investments by local investors (e.g., South Africa Regulation 28) or other capital controls, but this option could well backfire; iii) deficit monetization or bond purchases by central banks (QE), which also seems unlikely as both countries rely on independent central banks, with Brazil's needing to reassert itself after its autonomy was recently enshrined in the Constitution; iv) tapping fiscal buffers; v) further reliance on local markets, the path of least resistance, in our view.

The risks of relying on local markets appears lower for South Africa than for Brazil. First, the difference in magnitude of financing needs favours South Africa. Second, the domestic financial sector is very deep in South Africa, which should contribute to a better financing environment.[4] Third, debt rollover pressure should be lower in South Africa as the average maturity of South African local debt is 11.9 years, whereas the average maturity of Brazilian local debt is 3.4 years.

A More Credible Monetary Policy

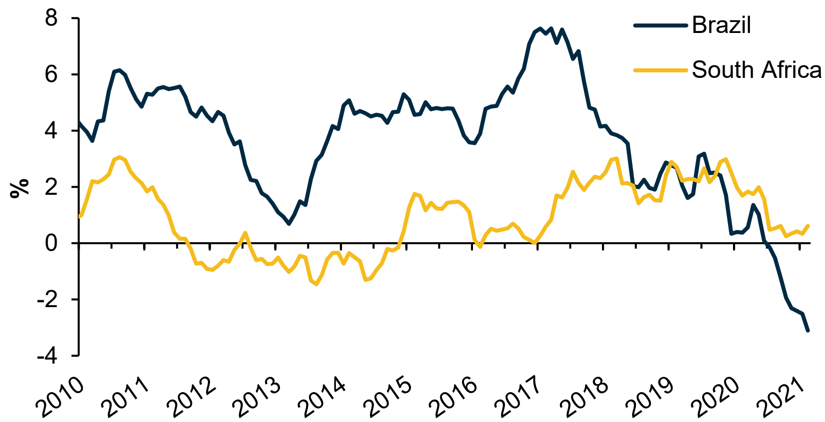
Moreover, the South African central bank has strong credibility and pursues relatively orthodox monetary policy, whereas the Brazilian central bank has yet to establish its reputation as a properly independent central bank—especially with foreign investors and against a challenging fiscal backdrop (Figure 5). Yet both central banks have been relative laggards among EM inflation-targeting central banks, failing to establish a track-record of meeting targets and smoothing inflation gyrations (Figure 6). Ideally, a country should experience very low inflation volatility while meeting its inflation target. Figure 6 shows that over the last two decades, average annual inflation in both countries has overshot central targets, with Brazil underperforming South Africa. We'd note that inflation volatility has been similar between the pair but has been relatively high compared to the broader cohort.

Partly owing to their respective track records, we expect Brazil's and South Africa's monetary authorities to follow different paths in the coming months. While we expect the South African Reserve Bank to remain on hold this year, we expect Banco Central do Brasil to continue the policy normalization process it initiated at its March policy meeting, with the pace and length largely determined by the inflation outlook and fiscal policy.

[3] In both Brazil and South Africa, FX reserves are more than double the outstanding foreign government debt

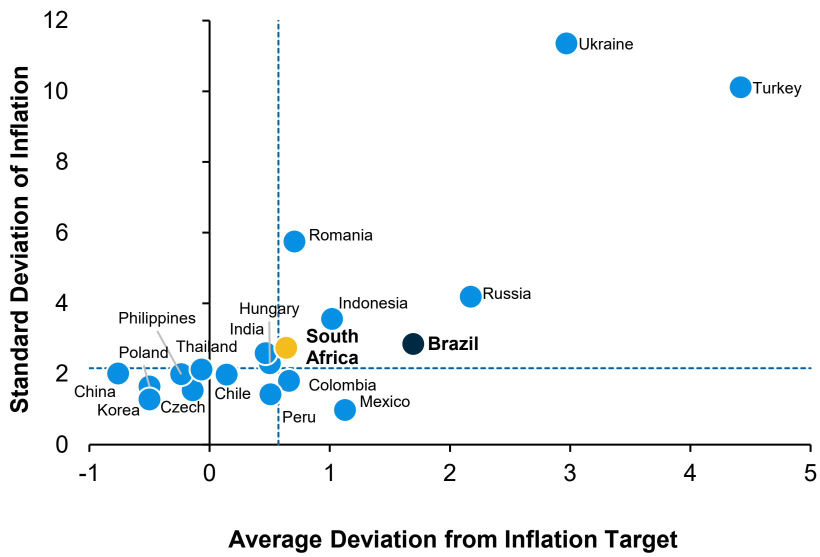
[4] Total assets held by institutional investors, excluding banks, amount to 142% of GDP, while these assets total about 82% of GDP in Brazil, as of March 2021. Source: Haver.

Figure 5: Ex-Post Real Policy Rate



Sources: National sources, Haver, PGIM Fixed Income.

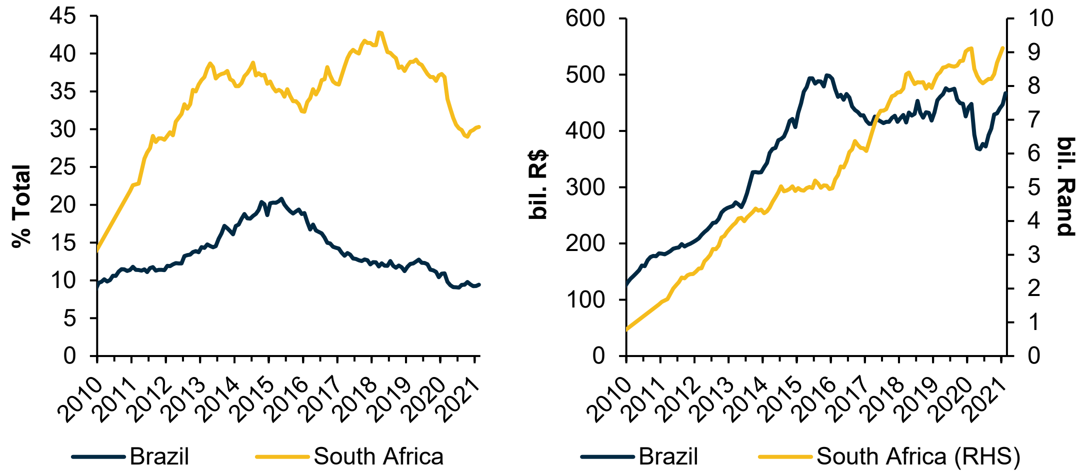
Figure 6: Inflation—Deviation from Target vs. Volatility



Note: Dashed lines indicate median of each series, as of February 2021. Sources: National sources, Haver, PGIM Fixed Income.

The combination of a more credible monetary policy and a more supportive backdrop for local debt has also attracted a higher participation of foreign investors in South Africa, with the country's downgrade to sub-investment grade not appearing to significantly deter foreign investment (Figure 7)—though the double-edged-sword nature of high foreign holdings of local debt may become more salient during risk-off episodes.

Figure 7: Foreign Holdings of Government Debt



As of February 2021. Sources: National sources, Haver, PGIM Fixed Income.

Conclusion

While both Brazil and South Africa have been on disappointing growth and fiscal paths in recent years and face severe challenges in the years ahead, we currently prefer exposure to South Africa's local bonds versus Brazil's. Both have accumulated large government debts and Brazil is seemingly in a better situation in terms of debt sustainability. However, the unabated spread of COVID-19 and ensuing risks to Brazil's growth and fiscal outlook, coupled with the resurgence of political risk, intensify the headwinds faced by Brazil through next year. Moreover, South Africa seems better positioned to reach a stronger growth path and meet its financing needs domestically, owing to the depth of the local investor base, strength of institutions, and lower short-term financing needs. Foreign participation is also higher in South Africa than in Brazil, contributing to an overall better financing environment. We believe this combination of a more favourable economic and political backdrop, more credible central bank, and more robust financing environment should be supportive of South Africa's local bonds relative to Brazil's local bonds going forward.

Notice: Important Information

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of April 2021.

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. (“PFI”) company. Registration as a registered investment adviser does not imply a certain level or skill or training. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Netherlands B.V., located in Amsterdam; (iii) PGIM Japan Co., Ltd. (“PGIM Japan”), located in Tokyo; (iv) the public fixed income unit within PGIM (Hong Kong) Ltd. located in Hong Kong; and (v) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore (“PGIM Singapore”). PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. Clients seeking information regarding their particular investment needs should contact their financial professional. These materials represent the views and opinions of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person’s advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. **All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.**

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income’s personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income’s clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income’s Form ADV.

In the **United Kingdom**, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority (“FCA”) of the United Kingdom (Firm Reference Number 193418). In the **European Economic Area** (“EEA”), information is issued by PGIM Netherlands B.V., an entity authorised by the Autoriteit Financiële Markten (“AFM”) in the Netherlands and operating on the basis of a European passport. In certain EEA countries, information is, where permitted, presented by PGIM Limited in reliance of provisions, exemptions or licenses available to PGIM Limited under temporary permission arrangements following the exit of the United Kingdom from the European Union. These materials are issued by PGIM Limited and/or PGIM Netherlands B.V. to persons who are professional clients as defined under the rules of the FCA and/or to persons who are professional clients as defined in the relevant local implementation of Directive 2014/65/EU (MiFID II). In certain countries in **Asia-Pacific**, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In **Japan**, information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In **South Korea**, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In **Hong Kong**, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap.571). In **Australia**, this information is presented by PGIM (Australia) Pty Ltd (“PGIM Australia”) for the general information of its “wholesale” customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the FCA (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In **South Africa**, PGIM, Inc. is an authorised financial services provider – FSP number 49012. In **Canada**, pursuant to the international adviser registration exemption in National Instrument 31-103, PGIM, Inc. is informing you of that: (1) PGIM, Inc. is not registered in Canada and is advising you in reliance upon an exemption from the adviser registration requirement under National Instrument 31-103; (2) PGIM, Inc.’s jurisdiction of residence is New Jersey, U.S.A.; (3) there may be difficulty enforcing legal rights against PGIM, Inc. because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada; and (4) the name and address of the agent for service of process of PGIM, Inc. in the applicable Provinces of Canada are as follows: in **Québec**: Borden Ladner Gervais LLP, 1000 de La Gauchetière Street West, Suite 900 Montréal, QC H3B 5H4; in **British Columbia**: Borden Ladner Gervais LLP, 1200 Waterfront Centre, 200 Burrard Street, Vancouver, BC V7X 1T2; in **Ontario**: Borden Ladner Gervais LLP, 22 Adelaide Street West, Suite 3400, Toronto, ON M5H 4E3; in **Nova Scotia**: Cox & Palmer, Q.C., 1100 Purdy’s Wharf Tower One, 1959 Upper Water Street, P.O. Box 2380 - Stn Central RPO, Halifax, NS B3J 3E5; in **Alberta**: Borden Ladner Gervais LLP, 530 Third Avenue S.W., Calgary, AB T2P R3.

© 2021 PFI and its related entities. 2021-3059

留意事項

※ 本資料は PGIM フィクスト・インカムが作成したものです。PGIM フィクスト・インカムは、米国 SEC の登録投資顧問会社である PGIM インクの債券運用部門です。
※ 本資料は情報提供を目的としたものであり、特定の金融商品の勧誘又は販売を目的としたものではありません。また、本資料に記載された内容等については今後変更されることもあります。
※ 記載されている市場動向等は現時点での見解であり、これらは今後変更することもあります。また、その結果の確実性を表明するものではなく、将来の市場環境の変動等を保証するものでもありません。
※ 本資料に記載されている市場関連データ及び情報等は信頼できると判断した各種情報源から入手したものですが、その情報の正確性、確実性について当社が保証するものではありません。
※ 過去の運用実績は必ずしも将来の運用成果等を保証するものではありません。
※ 本資料は法務、会計、税務上のアドバイスあるいは投資推奨等を行うために作成されたものではありません。
※ 当社による事前承諾なしに、本資料の一部または全部を複製することは堅くお断り致します。
※ “Prudential”、“PGIM ”、それぞれのロゴおよびロック・シンボルは、プルデンシャル・ファイナンシャル・インクおよびその関連会社のサービスマークであり、多数の国・地域で登録されています。
※ PGIM ジャパン株式会社は、世界最大級の金融サービス機関プルデンシャル・ファイナンシャルの一員であり、英国プルーデンシャル社とはなんら関係がありません。

PGIM ジャパン株式会社
金融商品取引業者　関東財務局長（金商）第 392 号
加入協会 一般社団法人 投資信託協会 、一般社団法人 日本投資顧問業協会
PGIMJ80705