MNI POLITICAL RISK ANALYSIS - Brazil Election Preview

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Executive Summary

Brazil holds a general election on Sunday October 2 to vote for the country's next president, national congress, state governors, and state legislative assemblies. The presidential election has been the market focus leading up to the election and, although the election remains competitive, former president Luiz Inácio "Lula" da Silva, who has sustained a double-digit polling advantage over incumbent President Jair Bolsonaro for much of 2022, is expected to retake office for a third term.

- The most likely outcome on Sunday is that neither Lula nor Bolsonaro achieves the required 50% vote share for victory in the first round of voting. If a majority is not achieved, then a second-round run-off will take place on October 30. The new president will be sworn in on January 1, 2023.
- Voting in Brazil is compulsory which means the second round of voting can see dramatic shifts in voting dynamics. Enforcement, however, is lax and there can be a tendency to overstate the influence of compulsory voting. In 2018, over 20% of the electorate did not participate in voting.
- The big question for election day is whether Bolsonaro will recognise the election result, should Lula win. Bolsonaro has oscillated between promising a peaceful transfer of power and laying the groundwork for challenging the result.

In this preview we offer a briefing on the Brazilian electoral system, a guide on the main parties contesting the election, an opinion polling chartpack, post-election scenario analysis (with assigned probabilities) and sell-side analyst views.

Electoral System

Brazil will elect all 513 members of the Chamber of Deputies and one third of the 81 members of the Federal Senate. The Brazilian Congress is likely to remain highly fragmented after the election. The largest party, the conservative Liberal Party, currently holds 15% of the 513 seats in the Chamber of Deputies.

As the current coalitions of the presidential candidates are insufficient to form a majority, a period of coalition building, with negotiation on matters of policy and administration, is expected to take place after the election. This process will likely hand significant power over policy to Congress and provide continuity in policy.

Main Presidential Candidates and Political Parties

Candidates

- **Jair Bolsonaro** – President (2019-), Federal Deputy for Rio de Janeiro (1991-2018) – Liberal Party (2021-) – VP Candidate: Walter Braga Netto (Defence Minister 2021-22, Chief of Staff of Presidency 2020-21, Chief of Army General Staff 2019-20)
- **Luiz Inácio 'Lula' da Silva** – President (2003-13), President of the Workers' Party (1990-94), Federal Deputy for Sao Paulo (1987-1991) – Workers' Party (1980-) – VP Candidate: Geraldo Alckmin (Governor of Sao Paulo 2001-06 & 2011-18, Federal Deputy for Sao Paulo 1987-94, Presidential Candidate 2006 & 2018)
- **Ciro Gomes** – Deputy for Ceara (2007-11), Minister of National Integration (2003-06), Minister of Finance (1994), Governor of Ceara (1991-94) – Democratic Labour Party (2015-) – VP Candidate: Ana Paula Matos (Vice Mayor of Salvador 2021-)
- **Simone Tebet** – Senator for Mato Grosso do Sul (2015-), Secretary of State for Government of Mato Grosso do Sul (2013-14) – Brazilian Democratic Movement – VP Candidate: Mara Gabrilli (Senator for Sao Paulo 2019-, Federal Deputy for Sao Paulo 2011-19)

Parties

- **Liberal Party** – *Partido Liberal,* PL – Pro-Bolosnaro 'For the Good of Brazil' Coalition – Conservative, populism, economic liberalism – Founded: 2006 - 76 Deputies, 8 Senators
- **Progressives** – *Progressistas,* PP – Pro-Bolsonaro 'For the Good of Brazil' Coalition – Centre-right, Conservative liberalism, federalism, social conservatism – Founded: 1995 - 58 Deputies, 8 Senators
- **Workers' Party** – *Partido dos Trabalhadores,* PT – Pro-Lula 'Let's Go Together for Brazil' Coalition – Left-wing, populism, Lulism, democratic socialism – Founded: 1980 – 56 Deputies, 7 Senators
- **Brazil Union** – *Uniao Brasil,* UNIÃO – No Coalition – Centre-Right, liberal conservatism, economic liberalism – Founded: 2021 – 51 Deputies, 6 Senators (Centre-Right)
- **Social Democrat Party** – *Partido Social Democratico,* PSD – No Coalition – Centrism, liberalism, federalism – Founded: 2011 - 46 Deputies, 11 Senators
- **Republicans** – *Republicanos* – Pro-Bolsonaro 'For the Good of Brazil' Coalition – Right-wing, social conservatism, Christian democracy, nationalism – Founded: 2003 – 44 Deputies, 1 Senator
- **Brazilian Democratic Movement** – *Movimento Democratico Brasileiro*, MDB – Pro-Tebet 'Brazil for Everyone' Coalition – Economic liberalism, centre-right, catch-all – Founded: 1965 – 37 Deputies, 13 Senators
- **Brazilian Socialist Party** – *Partido Socialista Brasileiro,* PSB – Pro-Lula 'Let's Go Together for Brazil' Coalition – Left-wing nationalism, social democratic – Founded: 1947 – 24 Deputies, 1 Senator

- **Brazilian Social Democracy Party** – *Partido da Social Democracia Brasileira,* PSDB – Pro-Tebet 'Brazil for Everyone' Coalition – Centrism, Third Way, Social Democracy, Economic liberalism, social liberalism – 22 Deputies, 6 Senators
- **Democratic Labour Party** – *Partido Democratico Trabalhista* ,PDT – No Coalition – Left-wing, democratic socialism, left-wing nationalism, populism – Founded: 1979 - 19 Deputies, 3 Senators

Policy

Lula was seen as an unknown quantity when he first took office in 2003 but developed a reputation as a pragmatic operator with whom the business community could work. This has, to some extent, ameliorated the political risk associated with major policy shifts in the event of a Lula presidency. The decreased market risk of a Lula government was underscored this month when ex-central bank chief Henrique Meirelles publicly endorsed Lula and raised market optimism that he may play a promient role a new Lula administration.

Lula's running mate Geraldo Alckmin supplies additional establishment credibility to Lula's campaign. Alckmin has been elected governor of Sao Paulo four times and the alliance with Lula suggests a moderate economic agenda.

Climate

Under Bolsonaro, deforestation in the Amazon region increased to a 15-year high. Should Lula win, the country is likely to see an overhaul of climate policy. Lula said recently that Brazil should be "in a position of leadership" on climate.

Reimagining climate policy will be a challenge for Lula. Much of the Amazon deforestation is carried out by small-scale loggers and presenting an economically viable alternative for this industry will be bureaucratically complex and enforcement would strain the public purse. Moreover, reforms will be subject to obfuscation from a powerful bloc of right-wing lawmakers seen as friendly to agribusiness within Congress.

Lula has been ambivalent on energy. He has supported the idea of transition to clean energy but has also pledged to expand drilling and refining by Petrobras to ensure energy security.
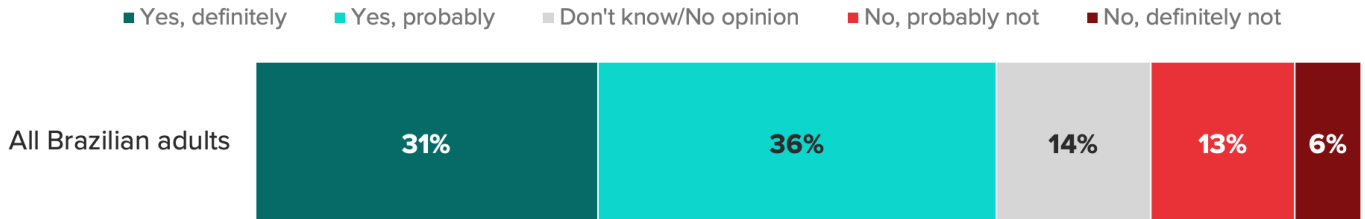
Transfer of Power

Brazil's electoral system is internationally praised but, according to a recent Morning Consult survey, only 31% of the respondents believed the election will be "free and fair."

Bolsonaro has repeatedly questioned the integrity of Brazil's electronic voting system which has been in place since 1996. He made a failed attempt to replace the system with a paper system and since continued to claim that the electronic system could be subject to fraud.

If Bolsonaro alleges fraud on election day, he could trigger a constitutional crisis and risk the involvement of the military but much of the risk hinges on the election being close enough for Bolsonaro to credibly claim that electoral irregularities took place.
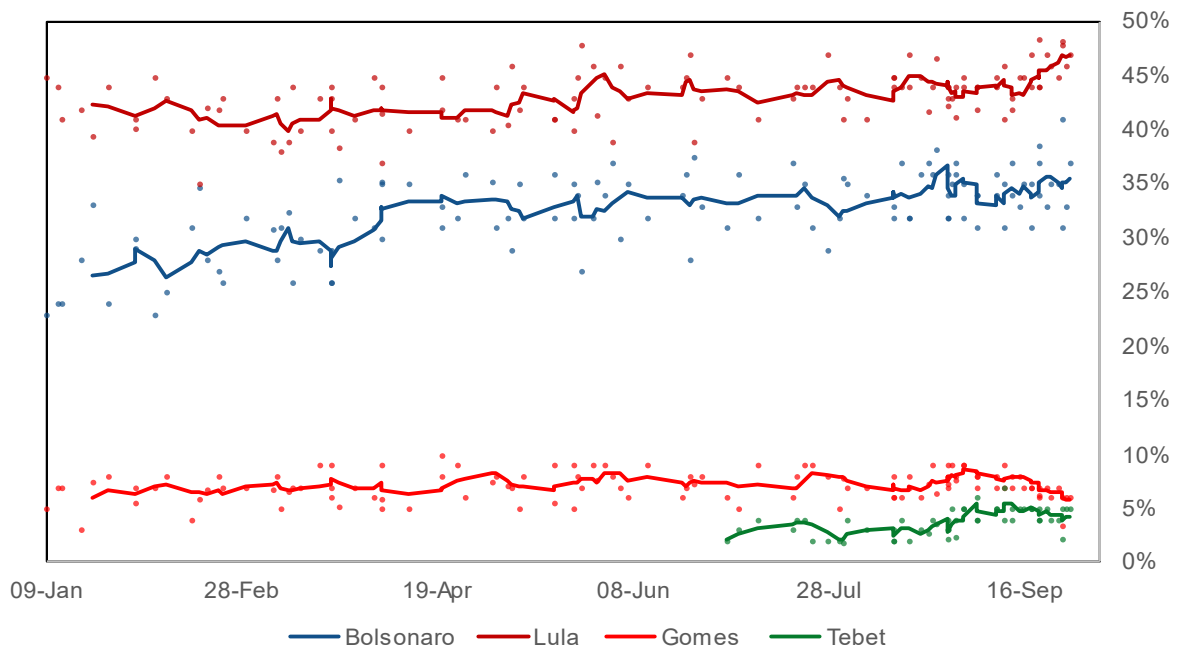
Chart 1: Will The Brazilian Election Be Free And Fair?

■ Yes, definitely   ■ Yes, probably   ■ Don't know/No opinion   ■ No, probably not   ■ No, definitely not

| All Brazilian adults	31%	36%	14%	13%	6%

Source: Morning Consult

Opinion Polling Pack Chartpack

Chart 2: Brazilian Election Opinion Polling by Presidential Candidate, % and 5-Poll Moving Average (First Round)

— Bolsonaro   — Lula   — Gomes   — Tebet

Source: Quaest/Genial, XP/Ipespe, Exame/Ideia, PoderData, Modalmais/Futura, MNI

Chart 3: Brazilian Election Opinion Polling by Presidential Candidate, % and 5-Poll Moving Average (Second Round)
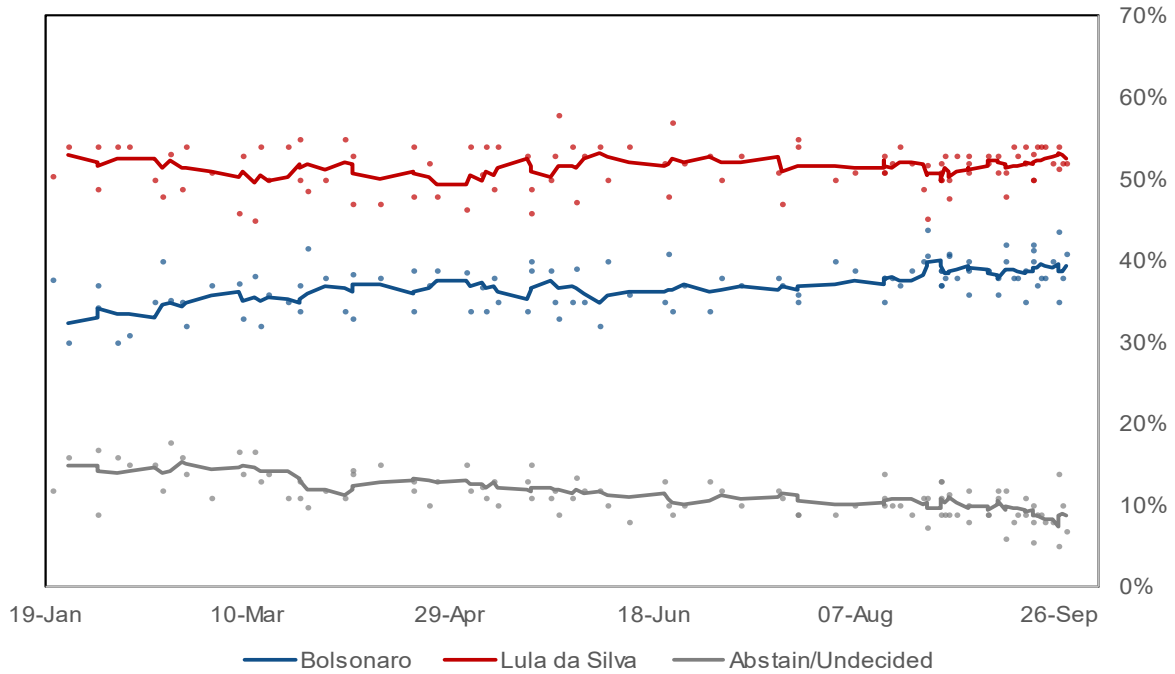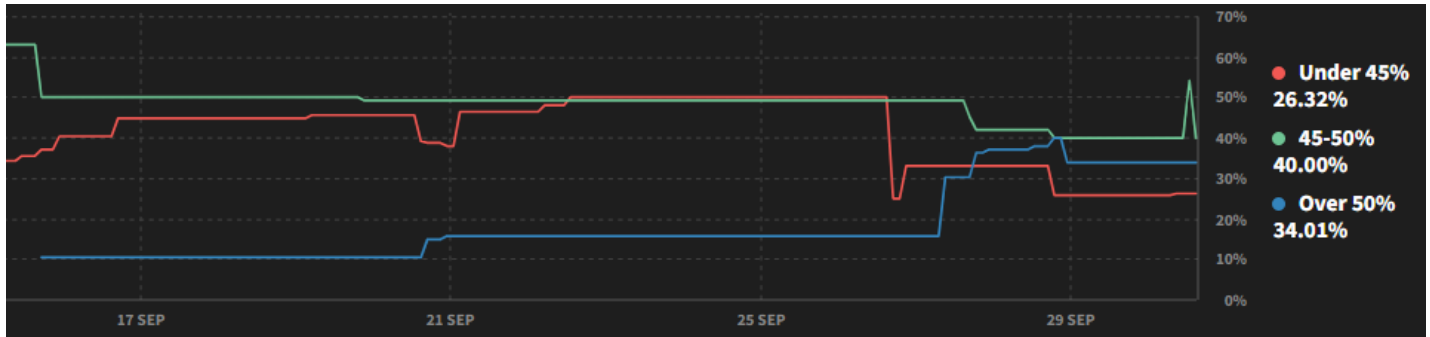

Source: Quaest/Genial, XP/Ipespe, Exame/Ideia, PoderData, Modalmais/Futura, MNI

Chart 4: Betting Market Implied Probability of Who Will Be Elected President, %
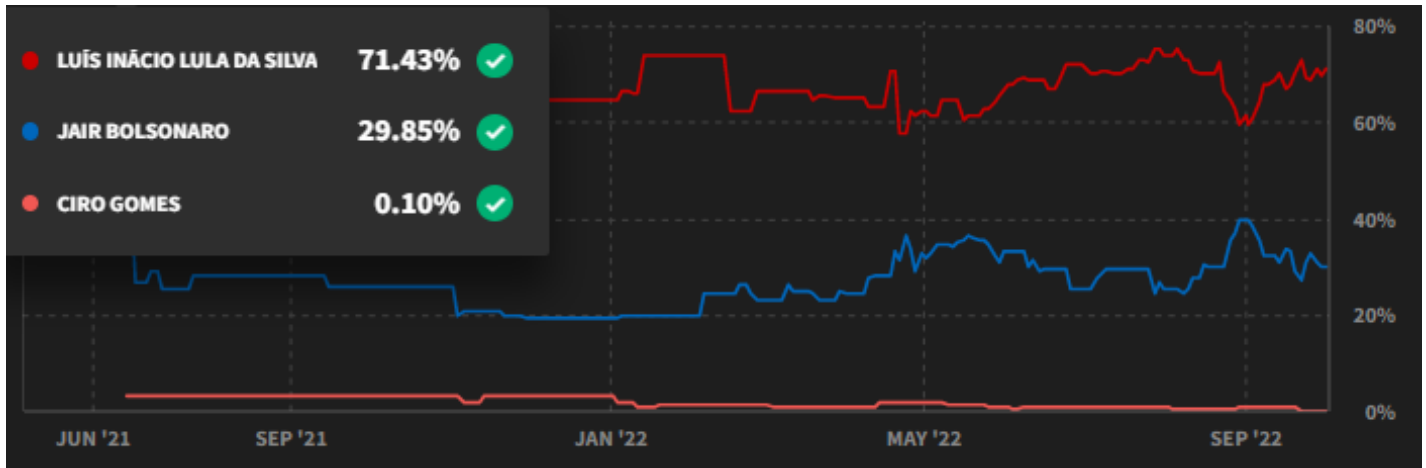
Source: Smarkets

Chart 5: Betting Market Implied Probability of Lula's Round One Vote Share, %

Source: Smarkets

Scenario Analysis

Neither Candidate Achieves Majority, Lula Wins Plurality – 65% Probability

According to pollsters, this is the most likely scenario. A second-round run-off will take place on October 30 and Lula and Bolsonaro will campaign for the votes of third- and fourth-placed candidates, Ciro Gomes and Simone Tebet. During the subsequent month of campaigning, Bolsonaro could lay further groundwork for challenging the eventual election result should he lose the contest.

Lula Wins Majority in First Round – 33% Probability

Lula's campaign has gained momentum in recent weeks despite a push from Bolsonaro to bolster support amongst working class voters with a broad raft of assistance packages. This scenario has increased in probability but support for Lula has likely peaked. As the support for third-place candidate Ciro Gomes has collapsed, his votes have tended to migrate to Bolsonaro.

No Candidate Wins Majority But Bolsonaro Emerges In First Place – 1% Probability

A significant underperformance by Lula combined with a major overperformance from Bolsonaro could see a run-off called but with the incumbent now seen as the favourite despite all pre-election polling suggesting that Lula held a sizeable advantage in any second round. For this scenario to occur it would also require both centre-left PDT candidate Ciro Gomes and centrist MDB candidate Simone Tebet to outperform their polling numbers and eat into Lula's support on the centre-left.

Analyst Key Comments (A-Z)

BNY Mellon

- Contrary to what is priced, we believe the likelihood of incumbent President Jair Bolsonaro winning the second round against ex-president Luis Inacio Lula da Silva on Oct. 30 is close to 50-50. Our three working scenarios for a second-round vote: Bolsonaro wins with just over 50%; Lula wins with less than 55%; and Lula wins with more than 55%.
- […] a market-based probability of Lula winning at 82%. We believe this is overly optimistic because, as shown in the Chilean constitutional vote polls, a meaningful

'silent margin' may be hiding behind alternative candidates. In Chile, virtually all the undecided votes assigned by pollsters ended up voting 'no'.

- In terms of market reaction, we think a Bolsonaro win will likely drive the BRL stronger, back below 5.00 per dollar, and begin to have more easing priced into the curve through 2023. The curve is priced for 300bp of easing over 2023, with -100bp priced for H1 that year.

- A Lula win will likely also induce the market to price easing, but that will likely differ between the two scenarios. A 'weak win' will likely have Lula opt for a pragmatic cabinet earlier, potentially bringing ex-Finance Minister and ex-central bank (BCB) President Henrique Meirelles into the newly formed government. We believe this would, in turn, reinforce the commitment to the spending ceiling introduced by President Michel Temer, which was strongly supported by Meirelles two weeks ago.

- A strong win – 55%+ margin – for Lula will likely drive the BRL weaker, while also have additional rate cuts priced for next year. Market turmoil could escalate, however, were the president to announce intent to eliminate the spending ceiling, as frequently mentioned in public speeches over the past few months.

- We believe investors will likely rebuild BRL longs after the elections. The main risk in our view, however, is a strong Lula win. That would likely trigger changes in the fiscal spending ceiling, followed by significant deterioration in debt dynamics. The new government may eventually reshuffle its cabinet, eventually steering back to pragmatism into 2024.

Citi Bank

- Lula is widely expected to win a third term as President in a runoff on October 30, though risks of a first-round victory exist. Markets will trade on i) the evolution of the voting intention gap between Lula and Bolsonaro, ii) changes to the third way candidate pool, and iii) updates on the potential makeup of Lula's cabinet.

- Markets are paying more attention to the potential cabinet composition under Lula. Clients seem to be increasingly discussing whether former President Lula's vice-presidential selection, Alckmin, could be appointed to a key cabinet position. This appointment would reinforce Lula's potential embrace of a more moderate political and economic agenda. In addition, reports on September 19 flagged that Henrique Meirelles, Brazil's ex-central bank chief, shared his support for Lula, kickstarting conversation that Meirelles may join Lula's economic team (market positive).

- Election implications on BRL FX are likely to materialize only over the next month, as we head into the runoff on October 30. Our strategists think BRL could continue to outperform in the near-term due to higher carry, just as our traders expect a short-term relief rally, with a stronger BRL FX and a bid for local FI, if the first-round result shows a tighter difference between Bolsonaro and Lula. BRL FX could find some pressure due to additional risk premium into the second round, though our traders think that both candidates will ultimately need to moderate their views to be competitive in the runoff.

- Rates could trade steeper, with notable tightening in the front-end, if Lula wins in the second round. Our strategists continue to suggest Receiving DI Jan 25s, given election risk across rates is somewhat lagging at this time. Beyond the election, BRL markets will be most influenced by the incoming President's prospective economic

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team, fiscal policy proposals, and the credibility of a new fiscal anchor, which both candidates expressed interest in changing.

JP Morgan

- Lula has consistently kept a sizeable advantage against Bolsonaro, suggesting local assets prices will likely not be significantly impacted if such a scenario materializes. A Lula victory would likely turn market focus to any potential signs of moderation, which could come from either a lower than expected vote difference, fewer seats in Congress or an Economy Minister viewed as having market-friendly policies.
- On the other hand, if Bolsonaro were to deliver a surprise, FX and rates seem to have space to rally at current valuations, whereas positioning is still light.
- First, a look at the polls. With elections a few days away, first round polls averages seem to have stabilized at around a 10%-pt difference between Lula and Bolsonaro (45.7% vs. 35.9% on average, respectively). Polls also suggest Lula still falls short of the 50% required for an outright first round win, but he is close. In a Second Round, the difference between the two main candidates climbs to 12%-pts on average, with also significant dispersion between pollsters.
- The size of the gap seems to indicate a victory by Lula is currently the most likely scenario expected, even if not in first round, and we think assets have priced this to a large extent. Polls show Lula has consistently kept a sizeable advantage against Bolsonaro over the past few months. Moreover, Bolsonaro's numbers have plateaued in recent weeks, while Lula has been gaining momentum. As such, it seems that the market's base case is already for a Lula's victory, most likely in a second round. Such a scenario would therefore have no major impact on local assets prices, in our view.
- If Lula were to win, market participants are likely to have a first assessment on the potential level of moderation of his administration by looking at the difference in votes (a win by Lula in Second Round and tighter results might imply a higher need to look for consensus with other political parties and hence a move to the center). The Congress distribution and any further insights about their government plan, such as any picks for the Economy Ministry, will also be key to evaluate this and likely to have relevant market impact.

SocGen

- Recent opinion polls show that a Lula (former president) vs Bolsonaro (incumbent) runoff round (30 October) is extremely likely. Opinion polls show Lula retaining close to a double-digit lead over Bolsonaro and, although the lead has declined in recent weeks, a Lula presidency could well be the market's baseline scenario right now.
- Irrespective of the presidential result, the Brazilian Congress could well remain highly fragmented as has traditionally been the case. For example, in the last election, the largest political party (The Liberal Party) got 15% of the seats in the 513-member-strong Chamber of Deputies. This type of fragmented polity is unlikely to change much.
- The current coalitions set up by the presidential hopefuls are not large enough to form a majority on their own in either house of Congress (only one-third of Senate seats are up for grabs at this election). As such, new bigger coalitions will need to be

formed after the election, requiring negotiations on both administrative and policy matters. Congress will continue to have a large, if not larger, say on policy outcomes.

- Market likely sees through the intricacies of Brazilian politics and probably doesn't expect any radical economic policy differences between a Lula or Bolsonaro regime, irrespective of what the candidates claim during their election campaigns. Nevertheless, to the extent the market is still concerned about potential major policy changes under a Lula government, an election surprise could lead to favourable asset price valuations.

UBS

- Between Lula's election in 2002 and the 2014 election, the second-round run-off elections have been between the PT and the PSDB. The PT won all four of these elections, but votes for the left diminished over time. In 2018, the run-off was between Jair Bolsonaro and Fernando Haddad from the PT, with Bolsonaro emerging victorious.
- The Superior Electoral Court (Tribunal Superior Eleitoral, TSE) releases the voting results for every election by electoral zone (the voting regions in every city in Brazil). The only data available is: 1) how many voters are registered; 2) how many registered electors showed up to vote; and 3) how many of the votes cast were valid.
- It is noteworthy that the figures for the Southeast, the largest region, show 44% of registered voters but 41% of votes cast in 2018, due to lower attendance and a higher number of null and blank votes.
- In the Southeast, we saw a trend since 2002 where votes for the right-wing candidate were increasing with each election. The current polls show a reversal of this trend, pointing to the first higher voter intention for a left-wing candidate in the run-off since 2010. Something similar is shown in the data for the South region, where the right-wing candidate typically had a larger advantage and is now almost tied, reducing Bolsonaro's advantage nationally.
- The Northeast shows stable voter intention for both sides since 2002 (Figure 8), around 70%/30%, a print that still hasn't changed based on recent polls. However, the North + Center West region saw a unique advantage for Bolsonaro in 2018, a difference that seems to have reverted back to 2014 levels based on recent polls.
- Even if we assume a tie in the Southeast, we estimate the valid votes in the second round would only change Lula's headway nationwide from 58% to 54%. Only a Bolsonaro victory greater than 60%/40% in the region (a reversal of current voter intentions as measured by the polls, or a result very similar to Bolsonaro's strong victory in 2018) would make Bolsonaro the winner in the second round, assuming votes in the other regions are in line with the current polls.

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