MARKET MEMO

The Real Cost of Lula's Victory

Alex O'Mahony
Head of Strategy

Fiscal uncertainty from the surprise Brazil result makes BRL unattractive.

Like many, we were suprised to see Lula secure a record 4th term from the Brazilian elections over the weekend. At the start of the month, we did warn in **BRL's Bolsonaro Boost** that ***"recent head-to-head polling had Lula and Bolsonaro statistically tied, meaning the first-round result shouldn't be interpreted as guaranteeing a Bolsonaro victory."***

The knee-jerk reaction in BRL and in most Brazlian assets has been swift and sharp, as traders try to digest just what this means for Brazil going forward. As just one example, the Ibovespa fell 13.9% (its worst day since early 2020).

The Lula victory is unambiguously a fiscal risk event in the near term. But the medium-term trajectory is what we're now more focused on, and this hinges almost entirely on whether Lula can credibly signal fiscal consolidation or not.

Here's how we now see things heading for Brazil.

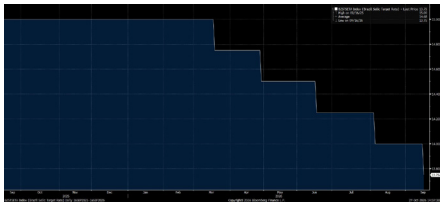
Fiscal Is The Core Concern

Our concern is that another presidential term could prioritise social spending and political commitments over the consolidation required to stabilise public debt.

It's less about Lula's victory in isolation and more about the absence of a credible financing framework for the expensive promises he made during the campaign. In fairness, both candidates pledged measures ranging from free public transport and cash-back schemes to debt forgiveness. And both had limited detail on how these initiatives would be

KEY TAKEAWAYS

- Lula's victory puts him in the spotlight without a credible fiscal policy path, with Debt to GDP levels not in his favour either for spending headroom
- On monetary policy, the BCB either have to cut further into economic weakness or pause to see how things pan out, both presenting a negative outcome
- We see USD/BRL trading higher and consolidating around 5.50 by year-end, with the medium-term fiscal trajectory being the firm driver





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funded. But as the left-wing candidate, Lula is more likely to pursue these at the expensive of fiscal prudence.

The starting position is already challenging. Public debt is projected to approach 90% of GDP next year, with IMF estimates suggesting a trajectory towards 100% over the medium term. Meanwhile, the headline fiscal deficit was approaching 10% of GDP ahead of the election, reflecting both underlying spending pressures and Brazil's substantial interest burden.

As we know from Europe and the UK, elevated borrowing costs create an uncomfortable feedback loop in that concerns over fiscal sustainability push up sovereign risk premia, raising debt-servicing costs and further complicating consolidation.

Despite the maths being against him, we'd argue the principal obstacle is actually political more than mathematical. Lula faces a conservative Congress, while constitutional amendments require three-fifths support in both chambers. Reforms affecting minimum-wage indexation or protected social expenditure would also challenge core elements of his political platform and could face judicial scrutiny. With less than 10% of federal expenditure discretionary, meaningful consolidation is difficult without addressing mandatory spending.

There are three upcoming events that we're going to be watching for fiscal soundbites:

- December: potential Finance Minister announcement
- January: early fiscal signals from the new government
- March: bimonthly fiscal report

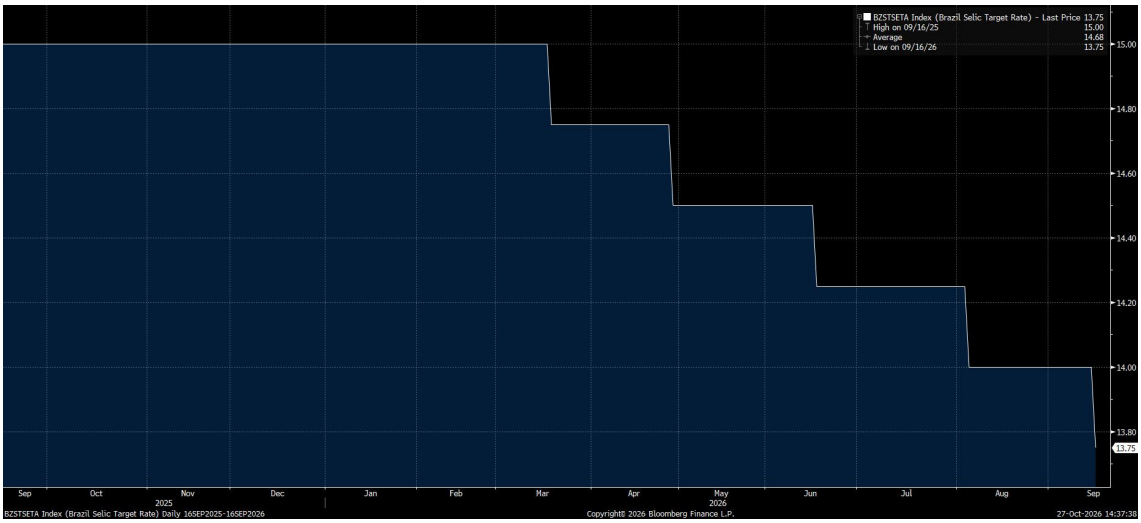
Monetary Easing Complication

Over the course of 2026, the Selic rate had been coming lower, with inflation still above target but coming under control. As we noted in our October note, ***"BRL's trajectory since the easing cycle began in March has been one of appreciation alongside rate cuts. To us this is a key signal that the carry story is being driven by real yield and fiscal optionality, not just the nominal rate level."*** We anticipated further rate cuts if Bolsonaro won over the coming year, but that this would be seen alongside BRL appreciation as the cuts were coming from a position of strength, with a good real yield acting to hold up the currency.

Now, the picture looks far less clear. For a start, we now expect the BCB to pause its easing cycle while it assesses the new government's fiscal plans. From there, either scenario of pausing or cutting could now act to weaken BRL rather than strengthen it. If we get some rate cuts, it will likely be due to economic weakness. Or, under a no-credibility scenario, rates remain higher for longer, which then weighs on growth and assets. In either case, it's not a great look.

Don't get us wrong, BCB independence is expected to be respected. Lula's track record from his third term showed no interference. But fiscal dominance risk is the key tail risk that could force the BCB's hand.

Exhibit 1: Brazil Selic Target Rate



Source: Bloomberg, AP Research

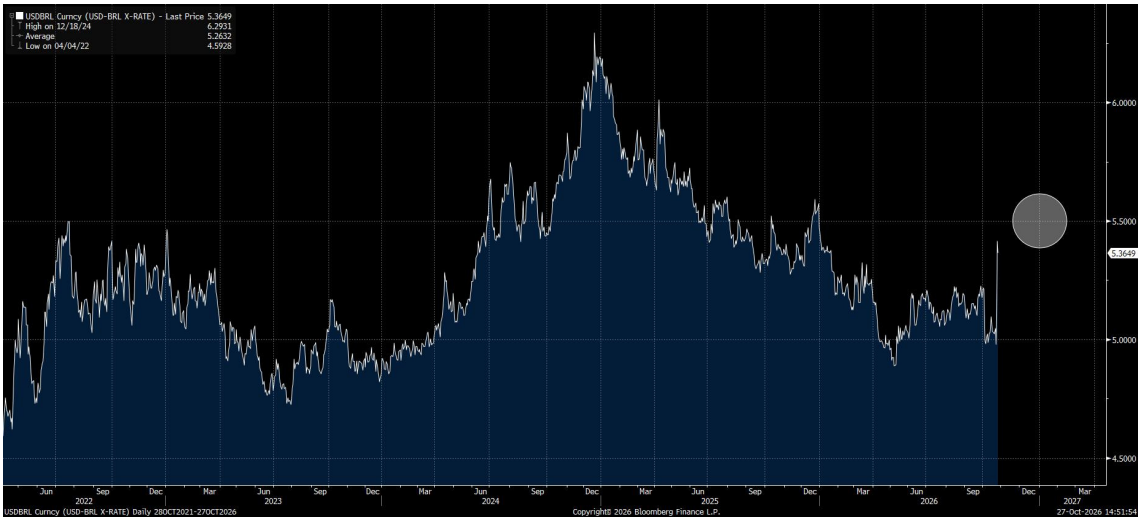
Our BRL Outlook

The Real fell 8% on Monday, and although it has partially recovered today down to the 5.30 region, we wouldn't be too optimistic. We closed out our USD/BRL risk reversal for a loss this afternoon.

For the coming few days, we think USD/BRL vol will remain elevated, with pricing disorderly. From there, we see it moving higher and target a move to 5.50 by the end of the year. Beyond the short-term price action, we reiterate that Lula's fiscal credibility and his actions in the coming weeks/months will takeover as the key driver for the currency, more so than the carry trade dynamics.

As we currently stand, we aren't hopefuly about his fiscal policy, and see the carry trade pillar being eroded as BCB moves from here are interpreted as being made. Therefore, we see no reason to hold BRL longs.

Exhibit 2: USD/BRL Spot



Source: Bloomberg, AP Research

We aren't looking to go outright long USD/BRL now given the risk of choppy price action. When the dust settles, and when we get news around the finance minster and more details on policy, we'll then be in a better position to have clarity on how to profit from this suprise turn of events in Brazil.

As ever, trade safe,
APFX

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