Brazil’s post-election outlook

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Lula’s reelection may prove less consequential for policy than the election result initially suggests, but fiscal risks and Brazil’s position between the US and China will remain central to the investment outlook.

At home, Luiz Inacio Lula da Silva (Lula) faces a constrained political environment, while abroad, Brazil’s strategic importance in the US-China relationship continues to grow. That domestic constraint reflects the strong performance of right- and center-right parties in the congressional elections, leaving the government dependent on centrist parties to pass legislation. Lula’s political influence could also diminish over time, given that he cannot seek reelection in 2030.

Brazil’s strategic balancing act

From a geopolitical standpoint, the election outcome is a setback for the US-Brazil relationship and a relative gain for China. On paper, Lula has pursued a foreign policy of “strategic autonomy,” but in practice this has involved closer ties with China. This sits uneasily with the US’s renewed strategic focus on the Western Hemisphere and closer engagement with Latin America, both crucial elements of its updated national security strategy.

Brazil’s value to China reflects not only the economics of a large, growing export market and critical source of raw materials, but also the strategic opportunity presented by closer ties with one of Latin America’s largest economies. In this context, a weakened Cuba makes Brazil that much more valuable as a strategic partner.

The complication for Brazil is China’s growing competitive threat. While Brazil remains one of the few countries to run consistent trade surpluses with China, that surplus has narrowed materially from its 2023 peak (Figure 1). Even with tariffs on Chinese steel and electric vehicles, it seems more likely than not that this erosion will continue.

Meanwhile, the US is also pushing more aggressively to secure the supply of critical minerals from Brazil. Earlier this year, the US Development Finance Corporation announced a $565 million loan to expand the Pela Ema rare earths mine in Brazil, helping to develop a Western-aligned source of rare earth elements, including heavy rare earths.

Brazil therefore remains an important arena for US-China geopolitical competition. Like India, it is seeking to retain strategic autonomy while recognizing the need to engage with both sides. If Brazil manages that balancing act well, it could use its position to advance its own strategic and economic interests.

A difficult path to fiscal stabilization

For markets, however, the more immediate issue remains fiscal policy. Federal spending increased as a share of GDP during Lula’s third term, driven mainly by transfers to households, social security, social programs, and mandatory spending on health and education. Tax revenues also increased significantly, but not enough to offset the rise in spending. With Brazil’s tax burden already around 33%–34% of GDP, the scope for further revenue increases may be limited.

Controlling spending will not be easy. Lula has historically opposed some of the measures that could have the biggest impact on mandatory spending, including smaller minimum-wage increases, delinking pensions, and other benefits from the minimum wage, and reducing minimum spending requirements for health and education. The government therefore has no easy options for stabilizing the fiscal position. This matters because public debt continues to rise and is projected to approach 88% of GDP next year (Figure 2).

Brazil's external position remains a source of strength, supported by a large trade surplus, robust FDI inflows, ample international reserves, and low external debt. Higher commodity prices could provide additional support but would do little to address concerns over Brazil's fiscal sustainability.

Higher rates remain a headwind for equities

Fiscal uncertainty reduces the scope for monetary easing. More than 52% of government debt is indexed to the SELIC, Brazil's benchmark policy rate, currently at 13.75%, making high rates particularly costly for the government. If economic and political pressures persist and inflation expectations deteriorate, the Central Bank of Brazil (BCB) may have limited room to continue cutting rates.

That would remain a headwind for domestic equities. Higher rates weigh on consumption, investment, financing costs, and valuations, while high household debt, elevated debt-service costs, and rising delinquencies leave consumers particularly exposed.

BRL to weaken while long-term yields remain elevated

We expect slower growth, inflation pressures, and heightened sensitivity to fiscal risk to push the Brazilian real (BRL) into a weaker post-election range, with USD/BRL trading around 5.60, versus 4.97 before the election. This would represent approximately an 11% depreciation in the BRL, alongside greater currency volatility.

Our post-election estimate uses the average USD/BRL level of 5.33 in Q4 2025–Q1 2026 as a reference point. During that period, expectations of a Lula victory and fiscal concerns were already present, while the currency benefited from Brazil's high interest-rate differential versus the US, favorable commodity terms of trade, and growing agricultural and oil exports to China. We raise this 5.33 reference level to 5.60 to reflect slower growth, higher inflation pressures, and greater investor sensitivity to fiscal risk following the election.

Lula has an incentive to avoid repeating the market reaction to the late-2024 spending package when USD/BRL reached 6.30. The sharp post-election tightening in financial conditions and a more conservative congress should also provide some restraint on spending. We therefore do not expect the BRL to revisit its late-2024 lows unless fiscal announcements disappoint materially.

Even if Lula were to follow a reasonable near-term fiscal path, investors may question whether an eventual improvement in the primary balance and lower interest expenses could create room for renewed social spending and a return to primary deficits. That concern could keep the fiscal risk premium elevated even if conditions improve and the BCB resumes easing.

Our base case is therefore for the BRL to remain structurally weaker, while longer-dated yields, particularly in the 5–10+ year area, remain elevated. Absent a negative fiscal surprise, weaker growth, tighter financial conditions and rising credit stress should limit further upward pressure on local yields.

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