

The Future Is Now

Why Brazil may be the strongest BRIC

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Of the four BRIC emerging economies, Brazil may seem the least compelling to global investors. Its reputation for endemic economic turbulence, spendthrift governments and swooning equity markets gave rise to the saying in decades past that “Brazil is the country of the future... and it always will be.” Yet that perception is at odds with more recent history in one of the world’s ten largest economies. Consider that:¹

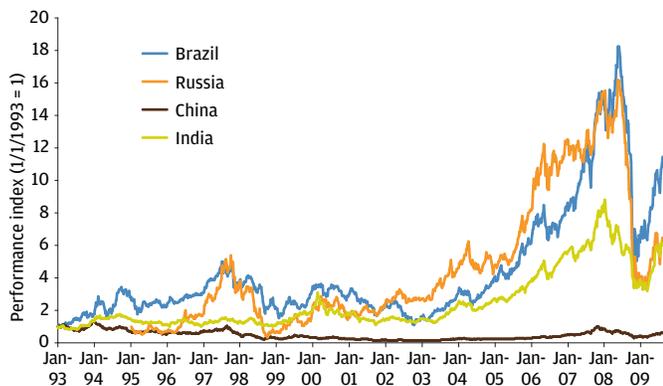
- Brazil is one of the first economies to stage a “v-shaped” recovery so far this year—with 2Q09 GDP up by an annualized 6%—unlike regional rival Mexico, which remains mired in recession with an annualized 4.4% drop in 2Q GDP.
- Government spending, which has won praise for its highly targeted stimulus to offset lower global demand, remains moderate with the ratio of gross domestic product (GDP)-to-debt at 43.1%—well below many industrialized nations.
- Inflation, which once appeared locked in to permanent double digit gains, stood at a modest 4.5% in August and has been below 10% since December of 2003.
- The MSCI Brazil Index has outperformed the MSCI China Index over every five-year period since 1998 and by a cumulative 61% in the most recent five-year period (through 6/30/09).
- Brazil is the largest single component of the MSCI Emerging Markets Index after China, accounting for approximately 15% of the index’s total capitalization.

Brazil is often tagged as a commodity play, but exports account for less than 15% of the country’s economy. Consumer spending, on the other hand, makes up about two-thirds of GDP and it is the buoyancy of that domestic demand that has allowed Brazil to largely skirt the worst of the global downturn. The Brazilian government responded to a record quarter-on-quarter GDP decline of 3.6% in 4Q08 by unveiling a series of subsidies and tax cuts. At the same time, Brazil’s central bank lopped off 500 basis points from the benchmark Selic interest rate since last fall, bringing it down to an all-time low of 8.75%. That combination of deft fiscal and monetary policies has rekindled business-to-business and consumer appetites for credit, goods and services. One sign of the rapid upswing: bank loans in June grew at the fastest pace in nine

¹ Source: J.P. Morgan, FactSet as of June 30, 2009, MSCI Barra

months to a record 1.31 trillion reais (\$701.2 billion). Meanwhile, the Sao Paulo stock exchange's Bovespa Index is up 85% year-to-date in U.S. dollar terms (and 50% in the local currency), making it one of the best performers globally so far this year and a perennial champion vis-a-vis equity markets in China, India and Russia (Exhibit 1).

EXHIBIT 1: BRIC BENCHMARK EQUITY INDICES, 1993-2009



Source: MSCI, Bloomberg

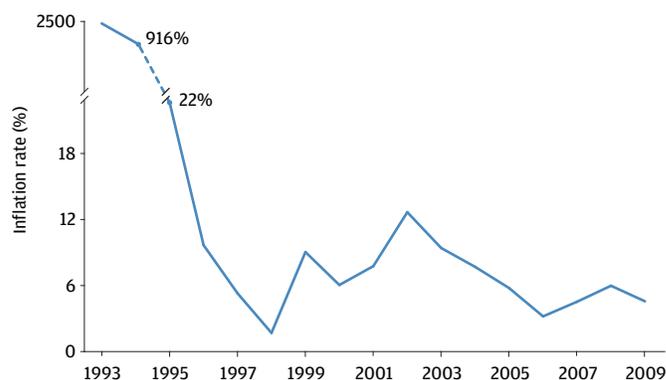
No More Contagion

Far from being a short-term jolt, we believe the economic activity in Brazil is likely to gain momentum in the coming quarters, resuming a nearly five year period of untrammelled growth that came to a premature end in late 2008 amid the worldwide credit crisis. It is significant in our view that a country which long seemed to be a leading case study for the “contagion theory” of vulnerable economies now appears to be one of the first to bounce back from the global downturn. Perhaps there is no better indicator of that than the investment grade rating bestowed on Brazilian sovereign debt by the major credit rating agencies last year and reaffirmed this year. That marked the culmination of a two-decade long quest dating from the country’s last default (in 1987) and brings Brazil in line with its BRIC peers.

That lower risk premium signals what our research indicates is a “second stage” of development that has catapulted Brazil into the top tier of emerging economies. In the past five years alone, Brazil’s GDP per capita has nearly doubled, its rate of industrial production growth has increased by a third and interest rates have been slashed in half. The government in Brasilia has kept spending in check, too, with net debt-to-GDP falling from a peak of 56.9% in September of 2002 to 43.1% in June

(up from a record low of 37.7% last November, primarily due to the recent stimulus effort) (Exhibit 2). The transformation has been driven by a commitment to inflation control and fiscal probity, supported by a tailwind of strong global commodity prices. The net effect has been to reduce the cost of capital and unleash a wave of pent-up demand for corporate financing, consumer credit cards and mortgages. At the same time, interest rates remain high enough to ward off the type of failure-prone investments that often accompany “free money.”

EXHIBIT 2: BRAZILIAN RATE OF INFLATION, 1993-2009



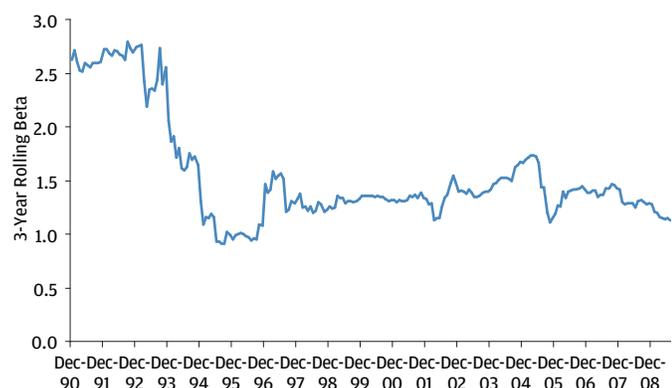
Source: Brazilian Institute of Geography and Statistics (IBGE)

A Decade of Reform

Yet what many investors remember best about Brazil are its “dark days” in the 1980s and 1990s when the economy was beset with a number of ills including hyperinflation, stagnant growth, a gyrating currency, ballooning trade deficits and massive public debt. Economic stability was further undermined by a volatile political climate, with the country’s first democratically elected president since the end of military rule impeached on corruption charges in 1992. Brazil has come a long way since then. Under the reformist administration of Fernando Henrique Cardoso, a series of reforms were implemented to deregulate industry, liberalize trade and privatize key sectors of the economy. Bolstered by the commodities boom and sounder fiscal policies in the early 2000s, Brazil now boasts vastly improved economic fundamentals, including a current account surplus and record levels of currency reserves. What’s more, the political environment has stabilized under Cardoso’s successor, President Luiz Inácio Lula da Silva, a leftist who has surprised detractors by demonstrating a pragmatic bent and strong commitment to economic growth throughout his two-term tenure, which ends in 2010.

For all of the above reasons, Brazilian stocks have become much less prone to wild swings than in the past. Indeed, volatility in Brazil's equity market has fallen sharply since the early 90s in relative terms when paired against other emerging markets. On a three-year rolling beta basis, Brazilian market volatility has dropped from 2.75 times that of emerging markets as a whole (i.e. versus MSCI EM) in February of 1993 down to 1.1 in July of 2009 (Exhibit 3).

EXHIBIT 3: BRAZIL VS. MSCI EMERGING MARKETS (3-YEAR ROLLING BETA)



Source: J.P. Morgan Asset Management. Data through July 2009.

What comes next is a key issue for Brazil—and global investors in Brazilian equity. While few expect the country to resume bad old habits, it faces some potential headwinds. On the macro front, rising government expenditure bears close watching, especially in the run-up to presidential elections next year. The country's primary surplus, a measure of how much revenue exceeds spending, declined to 2.0% of GDP in the 12 months through June, down from 3.7% at the end of 2008 and a peak of 4.3% in October last year. What's more, the current level is below the government's 2.5% target for calendar 2009 as a whole. Rising spending accounts for about two thirds of the deterioration in the balance sheet, though declining revenue also is a factor due to slow 1Q09 growth and stimulatory tax breaks. Our view is that the elections themselves are unlikely to radically change the political landscape or significantly alter Brazil's growth trajectory, but we do not rule out some uncertainties or policy-related concerns arising as we enter the electoral campaign.

The China Question

Of greater concern may be Brazil's growing dependence on China, a major consumer of Brazilian commodities which accounts for about 10% of its total exports. While our view is that a potential slowdown in Chinese demand would have a limited impact on overall GDP, it may reverberate to a greater degree on Brazil's equity market because commodity producers make up a hefty 58.8% of all publicly traded companies. We expect that to decline as more non-commodity companies go public in the months and years ahead. Even so, it is worth noting that—unlike Russia, which depends primarily on oil exports to fuel growth—Brazil's commodities are a diverse lot, including aircraft, coffee, iron ore and soybeans. From a purely valuations perspective, Brazil has had a strong run so far this year so there would appear to be few bargains left on the Bovespa. Although the market traded at a trailing average P/E of 12x as of July of 2009—up from a low of 8x in February—we find that attractive relative to the country's mid-to-longer term growth prospects and multiples in fellow BRICs China (18x) and India (20x). The future may be unwritten, but we believe the here and now of Brazil to be very compelling.

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