



Upside Surprises In Brazil

A Closer Look At Equities

Much has been made of the increasing challenges for foreign investors when investing in Brazil. Most of these obstacles existed during the years leading up to the Lehman Crisis of 2008, in which Brazilian securities easily outperformed other markets worldwide. This paper examines the case for investing in the Brazilian Real (BRL) and BRL-denominated securities in the future. One of the most noteworthy trends since the Lehman Crisis has been the persistent growth differentials between G7 and BRIC economies. Broadly speaking, BRICs have grown at over twice the pace of the G7. The average pace of growth in Brazil during the period Q3 2008–Q2 2012 was 2.4% (q/q SAAR) compared to 0.5% in the US, 0.0% in Japan, 0.6% in Germany, -0.8% in the UK and 1.3% in Canada. At the same time, Brazilian inflation has readily outpaced inflation in the G7. The Brazilian Consumer Price Index (CPI) has averaged 5.6% y/y on a monthly

balance of payments surplus has led to long-term currency appreciation. USD/BRL initially soared to a high of 2.5127 on December 8, 2008 from a low of 1.5600 on August 1, 2008 during the crisis, before steadily sliding to a fresh low of 1.5391 by July 26, 2011. Consequently, high interest rates and currency appreciation contributed to strong foreign investment in Brazil before the Lehman Crisis. While Brazilian deposits and fixed income continue to be profitable on a hedged and unhedged basis, they are not nearly as profitable as before Lehman.



By Michael Woolfolk, Senior Currency Strategist

The surprise is the performance of Brazilian equities. Brazilian Bovespa Stock Market Index outperformed virtually all major exchanges in the years leading up to the crisis. Since then, it has not only underperformed most Latam markets, but is has also underperformed major global indices including the US Dow. The Bovespa is down -8.3% on a local basis since June 30, 2008, compared to a gain of 19.4% for the US Dow, a gain of 44.6% for the Mexico Bolsa, a gain of 43.9% for the Chilean Select Index, and a gain of 16.6% for the Argentine Merval. On a currency-adjusted basis, the results were the same. While the Bovespa was undoubtedly overvalued before Lehman, government regulation to discourage foreign investment in Brazilian equities also played a role. Fortunately, we don't invest looking at past returns. The Brazilian economy is set to grow at a 4.0% pace over the next three years, roughly double the US. Moreover, the rapid expansion of consumer credit in Brazil has led to a geometric rise in consumer credit outstanding over the past 10 years. Foreign investment in local security markets is expected to accelerate as the local economy is fueled by a rise in both consumer spending and corporate earnings. Rather than look at the last four years of equity underperformance as a negative, we choose to see it as a positive, with upside surprises to economic growth providing opportunities to invest in undervalued local equities with the USD/BRL rate expected to remain steady around the 2.00 level.

Foreign investment in local security markets is expected to accelerate.

basis during Q3 2008–Q2 2012, compared to 1.8% y/y in the US, 0.4% in Japan, 1.6% in Germany, 3.4% in the UK and 1.8% in Canada. Economic growth in Brazil has outpaced the G7 throughout the Lehman Crisis and since, while Brazilian inflation has been materially higher than that in the G7 over the same period. Has this faster pace of growth over the past four years generated superior market performance? The evidence may surprise you.

Brazil has a history of structural inflationary pressures amidst varying currency regimes that have ranged the spectrum from a fixed peg to a free float. To encourage demand for local fixed income securities and curb borrowing, monetary policy has been restrictive with relatively high interest rates. High IR differentials compared to developed markets have attracted foreign investment into Brazilian deposits and fixed income securities for many years. While Banco Central do Brasil has cut interest rates over the last several years, the 10-year yield on government bonds remains at least 800 bps over comparable US 10-year Treasury yields, which compared to 900 bps at the end of 2007. Moreover, Brazil's

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