

Fabulous girls, fabulous beaches, fabulous returns... why Brazil is the place to be!

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This was the title of an email pinging into my inbox, inviting me to a hedge fund conference on Brazil, complete with the usual clichés of the country. I couldn't resist the temptation to borrow it. To this observer, it feels like the wider market has only just discovered Brazil in the last two years. Long the poor relation of its more famous and faster growing BRIC* cousins; India and China, Brazil has finally emerged into the spotlight thanks, in part, to some good policy execution, and, in part, a big slice of luck with global commodity prices.

There is no doubting Brazil's fabulous returns over the last five years or so (I'll leave the beaches and girls to readers' opinion). A remarkable journey from October 2002, with fears of a \$300bn debt default upon the election of left wing populist president Lula, to the granting of investment grade on April 30th 2008 – the MSCI Brazil index went from a low of 278 points to 4263...a dollar return of fifteen times your money!

The recent promotion to investment grade brings the inevitable question "is it all in the price?" In the short term, the answer is yes – market rates for Brazil's credit worthiness largely anticipated the upgrade, and short term rates are rising to combat inflation from above trend GDP growth of 6%. A zealous central bank is intent on maintaining its recently hard-won credibility and being mindful of Brazil's past habits of letting inflation run out of control.

For the longer term perspective, let's examine the report card of a country that has improved so much in the last decade, but still has so much to do.

Doing well or showing potential...

Central Bank – although not fully independent, Brazil's central bank has performed well in its mandate of controlling inflation and has worked hard to gain credibility. Long term inflation expectations and interest rates have fallen dramatically. Despite current global concerns on inflation, we must take a step back and remember that we are talking about mid single digit inflation in a country with a relatively recent history of hyperinflation.

Lula's government – for a supposedly left-wing firebrand who allegedly said Brazil was "too poor to pay its foreign debt", President Lula has done a good job of fostering financial stability. He has proven to be popular rather than populist, and his first administration continued the reform process of his predecessor, although progress on big reforms has ground to a halt and is unlikely to restart during the last two years of Lula's presidency. Most importantly, he chose economic orthodoxy when he could so easily have followed Argentina's path to default. We need to see some stomach for the continuation of big reforms (tax, pension and social security spending). These will not be forthcoming in the last two years of Lula's term, but what about the next president?

Oil – the announcement of the 8 billion barrel "Tupi" field and the other potential deepwater fields, mean Brazil could be sitting on a multi billion barrel oil legacy. It's deep and likely expensive to extract, and there will be arguments about how the benefits are used, but it will change the geopolitical and economic state of the country.

*BRIC – economic term referring to the combination of Brazil, Russia, India, and China.

Commodities – Brazil produces plenty of what the world wants right now (and that BRICS will continue to want), namely iron ore, steel and soft commodities. It is self sufficient in oil. The commodities boom has enabled Brazil to move from current account deficit to surplus with \$220bn of foreign exchange reserves - so there is money in the pot for a rainy day, accumulated while the sun shone on commodities. The authorities have used some of the commodity windfall to reduce the country's historical overdependence on foreign debt and, amazingly, become a net creditor to the world.

Land, food and biofuel – with huge reserves of existing and potential agricultural land, favourable climate and a well developed sugar cane ethanol industry, Brazil has the potential to increase its low cost food production. 70% of all new cars sold in Brazil can use both ethanol and gasoline, as Brazil has been producing ethanol as fuel for 25 years. If the US ever repealed the 54c per litre ethanol import tariff, Brazil could be at the forefront of a global ethanol trade.

Vibrant capital market with improving corporate governance standards – The creation of Brazil's Novo Mercado ("new market") with tighter governance standards and stability in the country, has led to an explosion of new issues onto the market (over 100 in the last three years). Whilst some have been of questionable quality, a capital market that allows for new capital raising improves investor choice and benefits the long term development of the economy.

Must try harder...

Investment in capacity - Brazil's small pick up in inflation is due to the country growing above potential (at about 5.5 - 6% GDP growth) and hitting capacity utilisation limits in certain sectors. Investment spending, at around 20% of GDP, will over time help alleviate these bottlenecks, but investment needs to be sustained at these levels to improve the potential growth rate of the economy.

Education standards – still poor. Lula recently stated that he wants to be remembered as the president that brought more schools to Brazil, and has earmarked Brazil's future offshore oil windfall for education spending. Productivity had been stagnant for years, and if Brazil is to continue its improvement path, it needs to invest in its human talent.

Savings rate – still low at 10% of GDP, unsurprising given a very high propensity to consume a new marginal Dollar in a country with a recent history of poverty. Raising the savings rate is a long term challenge, as the current government is preoccupied with pulling people out of poverty now via real wage growth, employment growth and subsidy programmes for the poorest families. In order to sustain higher future growth rates without relying on fickle external financing, the new middle class needs to begin saving.

Tax burden and red tape – with nearly 40% of GDP taken as taxes, the state is simply too big in Brazil. Combine this with a mind-bogglingly complex bureaucracy and you have a recipe for stifling entrepreneurialism. Indeed it often feels that successful entrepreneurs in Brazil are successful *in spite* of the system.

Openness of economy – despite being a large commodity producer, Brazil only really began to open its economy to the global markets in the 90s. Its economy is still relatively closed; its trade to GDP ratio (exports and imports over GDP) is low at around 21%, whilst its other BRIC peers have numbers of 50% or so and neighbour Argentina stands at 45%. The strength of the Real has not helped in recent years, but a more open trade mindset needs to be adopted and export red tape reduced.

What's next...

Over the last 5 years, Brazil's spectacular returns have meant the market has re-rated from a large PE discount to other emerging markets, to now trading in line with them. The huge progress made in this wonderful country has been recognised by the market.

For the market to re-rate to a higher (premium) multiple, Brazil must demonstrate that its economy can grow consistently at a higher range of 5% per annum, rather than the "old" average rate of 3%, without causing significant inflation. To achieve this, Brazil still needs much higher investment in productive assets, education and labour productivity, a more open economy and lower taxes. Investment grade helps but only at the margin. Improvements in investment will likely continue, but without a reform "shock", the pace of change is unlikely to accelerate. Progress has been great but there's no room for complacency.