Market & Investment Insights

Is Brazil still an attractive investment destination?

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Article Highlights:

- Slower growth and policymaking hiccups have caused investors to worry about Brazil's future prospects.
- Ratings agency Standard and Poor's recently downgraded the nation's debt rating, citing deteriorating government accounts, rising debt and weak growth prospects.
- In our view, the nation's vast natural resources and large, growing middle class still make Brazil an attractive investment destination for the long term.
- However, reforms are necessary, including liberalization of the labor market, simplification of the tax code, and much greater investment in human and physical capital.
- In terms of near-term policymaking, a more independent central bank and more credible fiscal policy would be well-received by investors.

The rise of Brazil's economy and middle class

Brazil's economy has more than quadrupled in size over the last decade. Nominal gross domestic product (GDP) rose from about $500 billion in 2002 to more than $2.2 trillion in 2013, surpassing both Russia and Mexico's GDP during that period, according to World Bank data. As one of the high-profile "BRIC" countries, Brazil attracted significant inflows from foreign investors eager to access a wide range of growth opportunities across asset classes. Accompanying this growth has been a rapid increase of Brazil's middle class. Over the past decade, tens of millions of Brazilians have risen out of poverty to join the middle class. This was due in part to developments in the economy, such as rapidly rising employment and higher wages, as well as government transfer payments from residents in the wealthier areas of the country to those in the poorer states.

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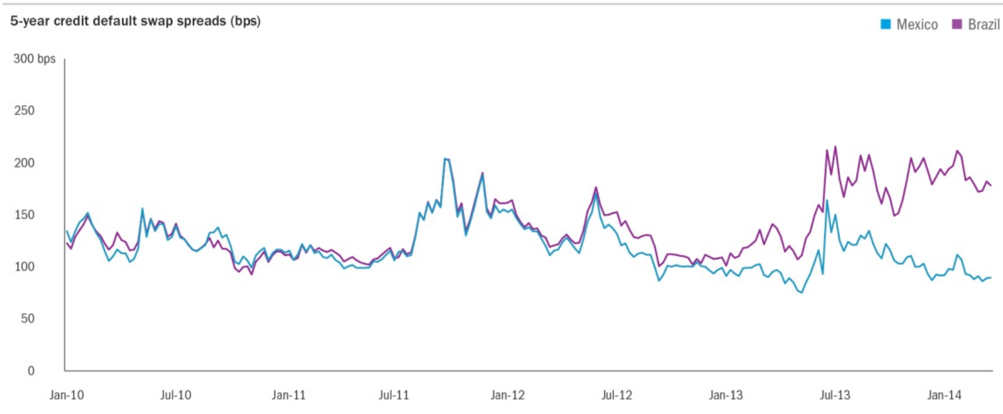
Like their middle-class counterparts around the developing world, these individuals are demanding not just mobile phones, computers, and washing machines, but less corruption, more social inclusion, low and stable inflation, and greater financial security.

More recently, however, Brazil's growth has decelerated, the middle class has become disenchanted with the government and investors have begun to worry about the prospects for government debt and deficits. After the relatively high average growth rate of 3.6% from 2001-2008, Brazil's growth slowed to an average 1.7% over the last two years, and the outlook for 2014 and 2015 is similarly subdued. It's now common to hear frustration from both investors and middle-class Brazilians over the country's low productivity, poor infrastructure, bloated public sector, and bureaucracy affecting citizens and businesses.

Credit downgrade

One stark example of how these economic drags are causing concern was Standard and Poor's (S&P's) decision in late March to cut its long-term, sovereign credit rating on Brazil's foreign currency debt to the lowest level of investment grade, citing deteriorating government accounts, rising debt and a tepid growth outlook. S&P cut Brazil's rating to BBB- from BBB but said its outlook for the country is stable. Even prior to the downgrade, investors viewed Brazil with more caution; spreads in corporate and sovereign bonds widened. Wider spreads on these financial instruments indicate increased risk associated with them. The contrast with Mexico is interesting. After a long period of little progress on reform, the new government in Mexico moved quickly to address long-standing, key reforms. As a result, the market is raising its expectations for potential growth and creditworthiness in Mexico and this is reflected in a narrowing of Mexico's credit default swap (CDS) spread relative to Brazil. The following exhibit highlights the dispersion in CDS spreads between Mexico and Brazil which began in early 2013:

Chart 1: The market has been pricing in a weaker growth outlook in Brazil



Source: Bloomberg

Structural reforms needed

The benefits of Brazil's large and growing middle class and vast natural resources are enormous but sweeping structural reforms are necessary for the nation to live up to its potential and continue to attract investment. Some statistics highlight this point. In the World Economic Forum's (WEF) Global Competitiveness Report for 2012-2013, Brazil ranked a respectable 48 out of 144 countries. In the WEF rankings, a lower number indicates a greater degree of competitiveness. While Brazil's overall WEF ranking was decent, its standing in several subcomponents of the index starkly show the many challenges it faces.

For example, Brazil scored poorly in these important categories, (all categories measured against 144 countries):

- Burden of Government Regulation – 144th
- Wastefulness of Government Spending – 134th
- Extent and Effect of Taxation – 144th
- Quality of Port Infrastructure -135th
- Quality of Air Transport Infrastructure – 134th
- Hiring and Firing Practices – 118th
- Flexibility of Wage Determination – 114th

There are many examples of how these poor results show up in the economy. Inflation, for example, remains at the upper end of the central bank's target of 4.5% plus or minus 2 percentage points. The lack of independence of Brazil's central bank has been one reason for rising inflation expectations because market participants at home and abroad thought the central bank would respond too slowly to rising inflation pressures so as not to slow economic growth further. Inflation has remained within the central bank's target range, because government-regulated prices (for example gasoline prices) have been kept artificially low. While a boon to consumers, these regulated prices have generated distortions in other parts of the economy. Petroleo Brasileiro (Petrobras), the government-owned oil and gas company, has borne the burden of low gas prices by purchasing refined product abroad at market prices while selling it domestically at subsidized prices. These actions have not been viewed favorably by Petrobras's other stakeholders.

Brazil's erratic actions with respect to tax policy also show up directly with foreign investors seeking to access the country's relatively high interest rates. The government has been quick to implement taxes on foreign inflows in the local fixed income market to slow the pace of currency strength from those inflows. The financial transactions tax, known as the IOF tax, was cut to 0% from 6%. The tax still exists, however, which means the government could reinstate it anytime it desires, which creates investor uncertainty over tax policy.

A lack of infrastructure hurts Brazil's agricultural and mining sectors. Brazil's natural resources are competitive in terms of cash costs and have the scale necessary to generate attractive returns. The country is the fourth largest agricultural producer in the world and is the world's largest sugar and coffee producer. It has a key global market share in meat, fruit, soybean and pulp as well as iron ore. However, lack of port and rail infrastructure limit expansion in these sectors as freight costs are higher relative to other countries. For example, the cost to transport grains from Matto

Grosso (a key Brazilian agricultural state) to the port is $3.30 - $4/bushel or 4-5 times that of similar freight costs in the US.

All of these constraints on potential growth are well known. Brazil badly needs more flexibility in the labor market, a simpler tax code, and much greater investment in human and physical capital. Such reforms will also attract more foreign direct investment to finance the current account deficit and make the country less dependent on short-term portfolio inflows.

Near-term concern: Exchange rate volatility

Reforms will help improve Brazil's long-term outlook, but investors should consider the potential for greater currency volatility in the short term. Reliance on portfolio flows to fund the current account and fiscal deficits has made the country vulnerable to sharp moves in the exchange rate. During 2013, for instance, the Brazilian real weakened 15% against the US dollar. As of early 2014, the currency is nearly 43% weaker than it was in 2011, which has hurt companies that issued U.S. dollar-denominated debt over the past few years.

Given the long history of foreign exchange (FX) depreciation and inflation volatility in Brazil, bank regulators strictly limit FX exposure within the banking sector. There are higher reserve requirements and capital charges for open FX positions, as well as a total exposure limit of 30% of a bank's capital. The largest banks in Brazil source most of their funding from deposits and domestic channels of liquidity. Foreign currency funding for the banking sector is low, less than 9% of total loans. These measures provide some stability for the financial system as a result of volatile currency depreciation.

In this highly dynamic FX environment, corporations that take actions to address foreign exchange risk are viewed favorably. Companies can lower the financial risk associated with US dollar debt by hedging the interest or principal payments on its debt. A company that has some US dollar earnings can use those earnings to partially offset the financial impact of FX depreciation on its debt. In this environment, exporters will do well since they can benefit from currency depreciation as their goods become more competitive overseas.

The credit boom

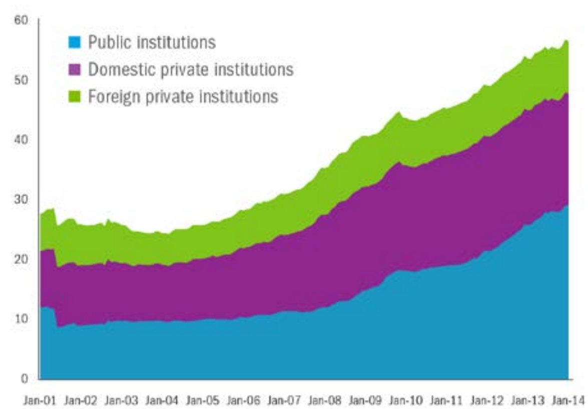
In addition to foreign exchange volatility, the rapid growth of credit in the banking system is a concern. The rising middle class demand for goods and services has fueled credit growth in Brazil. For the past 10 years, credit has risen from 24% of GDP in 2004 to 55% in 2013, as shown in Exhibit 2. Government-owned state and development banks in areas such as mortgage loans, payroll loans, and consumer loans have driven most of the increase. The state-owned banks' loan portfolios, which currently compose 51% of total system loans, have grown at 25-45% per annum over the past few years.

While this rapid growth has raised some concerns over asset quality and capital preservation at these banks, one must consider that the public banks have the lion's share of the deposits and the loans in the system. These banks can benefit from various degrees of government support such as a reduction in reserve requirements, additional liquidity and capital injections, among other measures. The concentration of the banking sector is high and any supportive measures can be effectively disseminated through the financial system. Additionally, the growth in loans has been predominantly driven by the mortgage segment which typically has a lower non-payment history than other types of loans such as credit card loans. Mortgages as a percentage of GDP were under 2% in 2002 and is currently 5.4% of GDP.

Although credit/GDP is high relative to its Latin American peers at 56% of GDP, the debt service ratio (the percentage of household disposable income needed to service debt) is stable at 21.5% as shown in Exhibit 3. Credit growth has been fast but the affordability of this credit for the borrower has been fairly stable and the growing credit segment is the mortgage sector which has a lower non-payment history than other loan types.

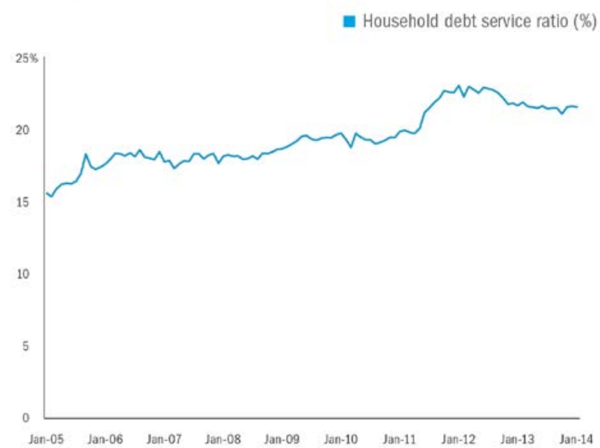
Chart 2: Brazil has seen a strong increase in credit availability particularly from the state-owned banks

Credit as a share of GDP by type of lender



Source: Central Bank of Brazil, Bloomberg

Chart 3: Household debt service ratio has fallen in recent years



Source: Central Bank of Brazil

All eyes on Brazil

Despite some recent challenges, we believe the investment opportunity in Brazil remains attractive for long-term investors. Brazil is the world's fifth most populous nation with about 215 million citizens, and has a high proportion of young people in the workforce. The nation's natural resources such as precious and base metals, oil and gas, and agricultural commodities attract foreign and domestic capital. But perhaps the greatest source of economic strength and investor optimism is Brazil's rapidly expanding middle class and the demand it creates for goods and services.

Is Brazil still an attractive investment destination?

Brazil's resources are vast and its potential is great, but the chief risk for investors is that its policymakers fail to make key structural reforms, such as investment in human and physical capital, liberalization of the labor market, and simplification of the tax code. Brazil has an opportunity to shine on the world stage—the 2014 World Cup—which can serve to demonstrate that Brazil's growth is translating into a modern nation worthy of deeper investment. Investors will also watch the October 2014 presidential election closely. This and other future elections provide political leaders with an opportunity to commit to the structural reforms needed to continue to make Brazil an attractive investment destination in the decades to come.

Brazil's investment climate is positive for the reasons mentioned above. Progress on structural economic reforms will help the economy grow faster and make the investment climate even more favorable.

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