

BRAZIL » With excellent fundamentals and a self-financing economic boom, Brazil's winning streak appears far from over

Brazil just keeps on scoring

main points

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» Thanks to its exports to China and the rest of the world, Brazil's trade surplus is running at about £23.3bn and its economic boom is self-financing

» The Brazilian government raised interest rates, which boosted the value of the country's currency, the real, and brought inflation down to about 3.1 per cent by the end of 2006

» Economic growth has picked up from an annual rate of 1.9 per cent five years ago to 3.7 per cent for 2006

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NICK SMITH

Think of Brazil and chances are the first thing that comes to mind is the world's best football team. If not, then carnival time, endless beautiful beaches or possibly even the Amazon and the rainforest. Investment professionals, on the other hand, now associate something completely different with the country – last year its stock market was one of the world's best-performers.

Economic powerhouse

Brazil is rapidly becoming an economic powerhouse capable of competing on the global stage, aided by the fact it is rich in many of the natural resources on which the rest of the world depends. In particular, it has been buoyed by demand from China, which needs huge quantities of iron ore for the steel mills that are underpinning its economic miracle – and Brazil is the largest single producer of the material. One Brazilian company alone, Companhia Vale do Rio Doce, has 40 per cent of the world market for iron ore.

Then there is soya, another crucial resource for developing nations such as China and India, which are desperate to feed their fast-growing populations. Brazil has millions of acres devoted to the growth of soya and is the world's largest exporter of the crop. Brazil is also moving ahead of Canada and Scandinavia as the cheapest exporter of pulp. The country has something of an unfair advantage over its northern hemisphere rivals – it gets most of its timber from its native eucalyptus trees, which grow faster and larger than trees in most of the top half of the world. This edge has enabled Brazil's Aracruz to become the world's largest pulp producer.

With its abundance in natural resources, Brazil should have performed more strongly economically in the past. But previous booms have typically foundered on huge trade deficits or a willingness to rely too much on overseas creditors to finance economic growth. This time around, however, the story is much more positive. Thanks to its exports to

China and the rest of the world, Brazil's trade surplus is currently running at about £23.3bn and its economic boom is self-financing.

Moreover, faced with rising inflation 18 months ago, the Brazilian government acted swiftly to raise interest rates. In addition to boosting the value of the country's currency, the real, this tightening of monetary policy quickly brought inflation down, reaching about 3.1 per cent by the end of 2006. As a result, interest rates have been repeatedly cut in recent times, which has opened the way for a domestic credit boom. So much so that consumer spending has produced a domestic boom that is now outpacing the growth of Brazil's export sector. Banks, retailers and the property sector are all benefiting hugely as a result.

Much of the credit for the very promising upturn in Brazil's fortunes has been laid at the door of president Luiz Inacio Lula da Silva. Elected in 2002, there were initially concerns that the left-winger might introduce policies harmful to the country's development. In fact, his pro-market policies have stabilised Brazil and strengthened its economy. Interest rates, standing at 26.5 per cent in early 2003, have fallen to 13.25 per cent and look set to come down further, and economic growth has picked up from an annual rate of 1.9 per cent five years ago to 3.7 per cent for 2006.

It was thus with some nervousness that investors in Brazil watched the run-up to the country's presidential elections in October, but Lula won re-election and his reforms will continue. Analysts detected something of a sea-change in the country's political environment. Lula's main opponent Geraldo Alckmin was at least as enthusiastic a supporter of economic reform as the president himself, backing the government on policies such as a programme of privatisations. In other words, the country's politicians are now much more closely aligned than in the past, reducing the scope for political upheaval to derail economic performance – one of the chief risks which investors in Brazil have had to grapple with in the past.

The political uncertainties of an election campaign depressed returns on Brazil's stock market for a brief period in the run-up to the poll, but shares ended the year strongly. Over 2006 as a whole, Brazil's Bopesc index rose by 31 per cent. And the return over the three years to the end of 2006 was more than 100 per cent.

The big question

One obvious issue for potential investors in Brazil is whether the country's excellent stock market returns can continue. Is there a danger that new investors, or those taking on additional exposure to the country, would be buying at the top of the market? There is, in fact, every reason to expect share prices to rise further during 2007 and beyond. The fundamental factors underlying Brazil's outperformance – hugely strong exports to demand-hungry countries such as China, allied with an improving domestic economy – remain in force and in many cases are actually heightening.

Moreover, valuations on Brazil's stock markets remain low by international standards, even compared with emerging markets in Asia and Eastern Europe. Brazil's market trades on an average price to earnings ratio of just 10, compared with, for example, 13 in the UK. In other words, share prices do not yet fully reflect the country's performance, let alone its potential for the future.

The clearest risk to ongoing returns from Brazil would be a fall back in global commodity prices. In addition to iron ore, copper, pulp and other resources, the country is also a major exporter of oil

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and prices have already fallen back in that market compared with the peaks achieved in 2006. Commodity experts, however, believe the world is in the middle of a 20-year super-cycle for price rises. Some analysts expect the oil price to hit \$100 within the next three years. And it is certainly difficult to see why demand for commodities should fall back, given the huge demand from China alone.

Moreover, Brazil's biggest exporters are not fly-by-night companies that would not be able to ride out short-term setbacks. Petrobras, for example, is now the world's seventh largest oil company and it has some of the cheapest extraction costs in the industry. Indeed, some of Brazil's biggest players have become so multi-national that they have now chosen to list their shares on the New York Stock Exchange, rather than the domestic bourse.

However, even without further gains on the world's commodity markets, Brazil's growth looks sustainable. The economic performance of the past five years has created increasing wealth amongst Brazil's growing numbers of middle class consumers. These consumers are no different to their middle class counterparts anywhere else in the world and the value of their spending is capable of sustaining an economy driven forwards by domestic factors. Ironically, one of the biggest things working in Brazil's favour is that so far its economic progress has been more modest than that of other emerging markets. The country is not a bubble phenomenon, but a long-term story of steady gains.

Economists think the nation is well-placed to weather a global slowdown this year, with a consensus forecast of growth of between 3.5 and 4 per cent for 2007, depending on how the US economy performs. From there, the economy should post further gains in 2008, particularly if the economic outlook elsewhere in the world picks up. In the meantime, the country is addressing one of its more basic problems – a need for better infrastructure, which until now has inhibited growth rates. Building programmes throughout the country are gathering pace, with government backing.

Tightening regulation

Brazil's regulators have also sought to crack down on another issue that has dogged the country in the past. Financial reforms on the country's stock exchanges means corruption is no longer a major concern for overseas investors. Two years ago, the Brazilian authorities split the exchange into several trading tiers, with the highest, Novo Mercado, applying the strictest disclosure rules and corporate-governance standards. These standards include the disclosure of insider trading by controlling shareholders and senior managers, and full voting rights for all shareholders.

Above all though, it is the fundamental story that is most exciting in South America. Brazil is a country with a population of 188m and a land mass that is as almost as large as the US. It is second only to Australia as the world's largest supplier of commodities. And it has been transformed from a developing economy 15 years ago to a country today that is almost energy independent, with foreign exchange reserves of almost £50.69bn and all its debts to the International Monetary Fund repaid.

Brazil's footballers may have missed out on World Cup glory last year, but the future for the team looks bright. Investors in the country can be similarly optimistic.

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Goal!: Brazil's economy is going from strength to strength