



216 Essex Street, Salem, MA 01970  
(978) 745-9233 | (800) 888-MGMT  
[www.ecabot.com](http://www.ecabot.com) | [info@ecabot.com](mailto:info@ecabot.com)

# BRAZIL – A BRIGHT FUTURE

*Brazil is uniquely positioned to succeed in the coming years.*

Written by: Dennis Wassung, Jr., CFA®  
Portfolio Manager

## Introduction

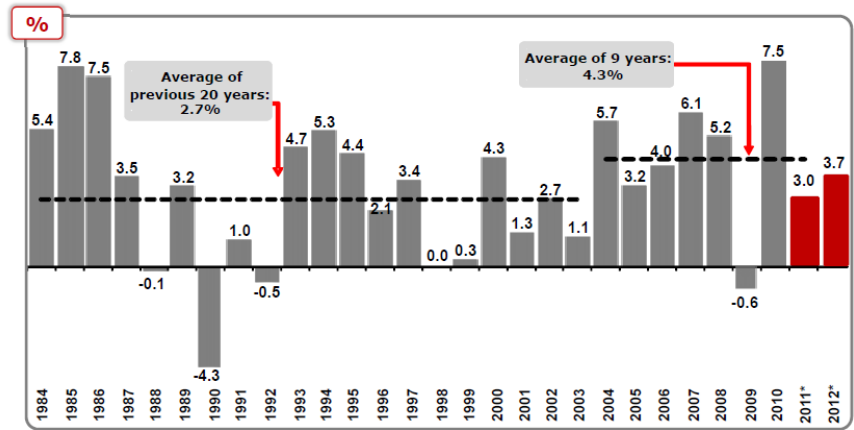
At Cabot Money Management, we believe it is important to get out and travel to the key places where we invest, to do research to better understand the companies and countries in a number of markets, and this is important in the emerging markets. I recently traveled to Brazil -- both São Paulo and Rio de Janeiro -- to attend a major Brazil equity market conference, meet with a number of leading companies, and to learn about and experience the Brazilian economy and culture. First and foremost, my trip to Brazil was excellent, and I was able to get an on-the-ground perspective for Brazil, its economy, its people, and the long-term opportunity the country has ahead of itself.

Brazil is uniquely positioned to succeed in the coming years. Brazil has immense natural resources (oil and gas, iron ore, sugar, food, etc.), that are increasingly important to the global economy (and countries like China, specifically). The emerging market middle-class expansion theme is alive and well in Brazil, with a very upwardly mobile population driving growth in domestic consumption, imports, and a range of industries. Roughly 25 million Brazilians have moved up into the middle class since 2002. While currently in a bit of soft spot with real GDP growth of about zero for Q3 2011, the sustainable growth outlook is solid -- with expectations of real GDP growth in the 3.5%-4.0% range, with inflation running around 5.5%-6.0% (currently 6.5% and declining). Overall, I believe Brazil continues to have a very bright (and profitable) future of strong growth and a growing importance in the global economy.

## Thoughts on Key Topics in Brazil:

**Growth** – Brazil has been on a strong GDP growth trajectory, like other emerging market countries, although volatility is magnified in certain periods of global weakness/crisis – so Brazil is not immune from global macroeconomics. Notably, after falling to -3.0% in Q1'09 (the peak of the financial crisis), real GDP climbed to 9.3% in Q1'10. All in, 2010 was a banner year, with real GDP growth of about 7.5% (after 2009's -0.6%) – its fastest growth in 25 years. With fiscal tightening beginning early this year and the global macro impact, growth has slowed through 2011 and was about zero in Q3'2011. Most expectations point to re-acceleration to about 3.5% growth (real) in 2012, with some improvement in Q4'11 and Q1'12. One of the drivers is fiscal easing that began in late August, with the central bank cutting the benchmark rate four times from 12.5% to the current 10.5%.

## Brazilian GDP

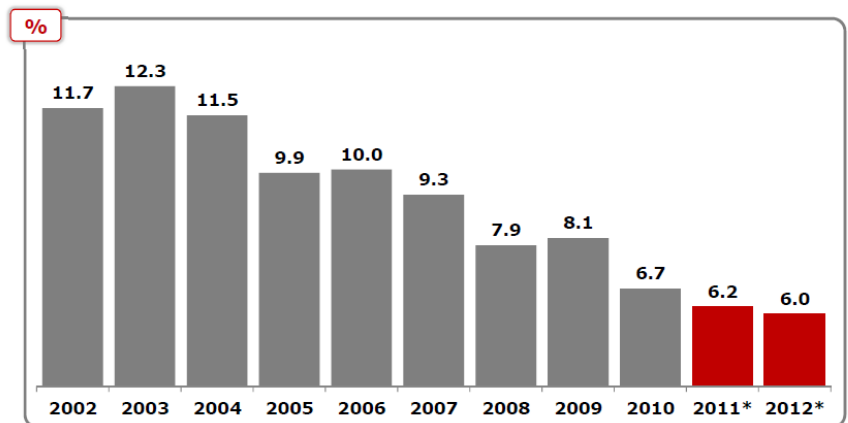


As of 12/12/2011  
 Source: IBGE  
 Prepared by / (\*) Projections: Bradesco - DEPEC

**Inflation** – While inflation is always a hot topic in Brazil given its history, inflation appears to be relatively in control. CPI is currently at 6.5%, easing from its recent 7.3% peak in September. Over the last three years, inflation (using CPI) has ranged between 4.2% (October '09) and the recent 7.3%. Inflation rose much of 2011, although is expected to ease back into the 5%-6% range. Worth mentioning, the government's target is 4.5% +/- 2 percentage points, so inflation has been running above target for about half of 2011. This is definitely an indicator to watch, as rising inflation is always a cautionary issue for investors.

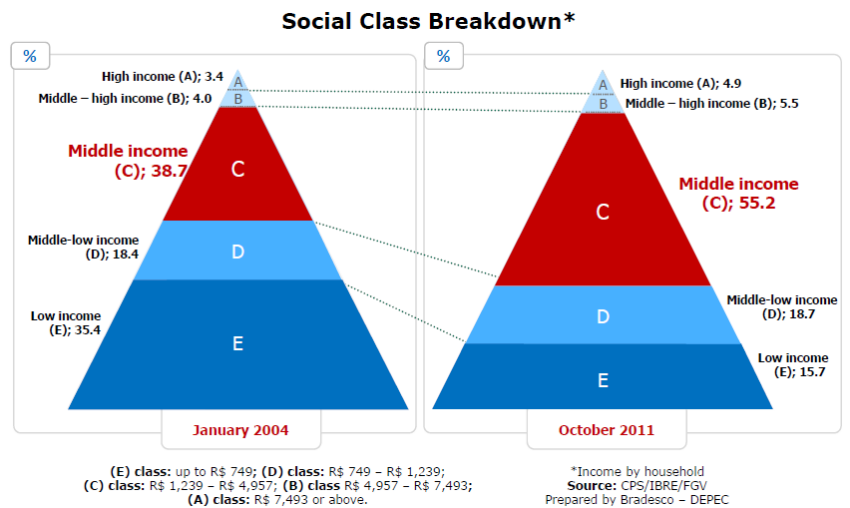
**Unemployment rates at record low** – The chart for unemployment rates in Brazil is quite impressive. In 2003, unemployment was running at about 12%, and it steadily declined from there. Even in 2009, unemployment was 8%, and today it is running about 6% -- which most people I spoke with consider full employment. This 6% range is a record low for Brazil, and is driving a very tight labor market. Per Morgan Stanley, Brazil needs to create 1.2 million jobs per year to hold the unemployment rate flat. Over the last seven years, Brazil has beaten that mark consistently, generating between 1.7M and 2.5M jobs per year. The unemployment rate is likely to remain at or near recent lows, supporting domestic consumption and income growth.

## Brazilian Unemployment Rate



(\*) Annual Average  
 As of 12/12/2011  
 Source: IBGE  
 Prepared by / (\*) Projections: Bradesco - DEPEC

**Social Mobility** – The middle class is expanding rapidly in Brazil, as unemployment is at record lows, and the government supports a “social inclusion” policy to keep driving more of the population into the middle class. Brazil uses “A Class” and “B Class” as the upper classes, “C Class” as the middle class, and “D” and “E” classes as the lower classes – with E class effectively the poverty level. Since 2003, the C class has expanded from 37% of the population to 50% in 2009, and government expects 56% of the population to be C class by 2014 – quite an impressive trajectory on a population of about 200 million people. About 25 million people have moved upward into the middle class since 2002. Brazil has supported this process through minimum wage increases and its “bolsa familia” program which pays low-income families to keep their kids in school (rather than having them work...). This is a big topic in Brazil and with more people in the middle and upper classes, domestic consumption and retail sales should remain strong.



Source: Banco Bradesco

**Wages** – With the tight labor market, wages are moving higher and the power has shifted to the labor force (and labor unions), away from employers. One clear example is the mandatory 12-13% minimum wage increase that is going into effect for 2012. The last increase was about 6-7%, so 2012 will see a sizable jump. Additionally, most wages (non-minimum wage) typically increase by more than the minimum. While this can/will be a cost headwind for businesses, the minimum wage increase alone is expected to add about R\$30 billion/US\$16.7B (R\$2.5bn/month) to domestic consumption, onto a roughly R\$2 trillion/US\$1.1 trillion base -- or add about 1.5percentage points of growth for 2012.

**Strong currency** – The Brazilian Real (R\$) currently trades at about R\$1.75 per US dollar (R\$100 = ~US\$57), although strengthened to R\$1.54 in July before the market sell-off. The Real has strengthened over most of the last decade, although weakened during the 2009 financial crisis, and again weakened sharply in the August 2011 time frame when world equity markets dropped sharply. While the currency is still volatile and is susceptible to weakening during periods of market turmoil, the longer term trend has been a stronger Real. This stronger Real is a headwind for many exporters in Brazil (although not commodities exporters), but is great for imports and the Brazilian consumer. Coupled with strong income growth, the stronger Real drives solid consumer spending through increased purchasing power.

Of course, the government is trying to protect its industry, and has imposed some steep import taxes on things like autos, consumer electronics, and others -- offsetting some of this currency benefit.

**Fast-growing real estate prices** – Real estate prices have been growing 25% per year over the last few years -- effectively doubling since 2009. The question of a real estate bubble is always a topic of discussion, although most expect price growth to "moderate" to the 15% level (remember, inflation is about 7.3% currently). While there are certainly million-dollar apartment prices (New York City-like prices) in wealthy areas of Rio de Janeiro, prices are fairly normal in most places.

**Commodities** – Brazil is a very wealthy nation when it comes to commodities. Huge deep-water oil finds, massive iron ore production, and major food and soft commodities positions, just to name a handful – all point to the country's ability to be a major global player in satisfying demand both in Brazil and throughout the globe. This resource position is one of the strongest in the world, and Brazil should be able to capitalize on this strength for many years.

**Oil** – Oil is a big deal in Brazil. Petrobras is the national integrated oil company (government controlled, but one of the world's largest publicly traded companies), and its "pre-salt" oil discoveries – thousands of meters below the sea floor – are expected to become a massive source of oil and natural gas production in the coming years, although requiring equally massive investments by the company and a long list of supporting services and global partners. Although this is a huge opportunity, there are potential technical challenges and impressive financial investments required. To enable Brazil to maximize its opportunity, the government has instituted "local content" restrictions, in an effort to bring a large portion of the investment required to the Brazilian economy. So, many companies are setting up shop in Brazil to build oil rigs, all types of support ships and other services products. Brazil is working to strengthen its economy and industry further through these massive investments in Brazil.

**Monetary policy** – The central bank shifted from tightening early this year (5 rate increases in 2011, beginning early in the year, impacting growth in Q3) to easing actions, which began in August – supporting growth in Q1 2012 and beyond. With economists' expectations of a 6-9 month lag between policy actions and impact on GDP growth, recent easing actions are expected to help the Brazilian economy in 2012. However, with inflation above the government's target (6.5% at the upper end), some investors question the recent easing actions. The good news is that with the short-term SELIC (benchmark) rate now at 10.5% (after four rate cuts), there's plenty of room for action in either direction. Interest rates are high in Brazil, however real interest rates are at their lowest level in 10 years. With 6.5% inflation, real rates stand at about 4.0%.

**Fiscal situation** – Tax revenues are growing at about 25% per year, although the government still runs at about a 3% deficit. Brazil has built its F/X reserves to about US\$350 billion over the last few years – double the 2008 level, and the net debt-to-GDP ratio is currently about 40% and declining. All in, a very healthy fiscal situation, similar to other large emerging market countries.

**Mercado Municipal de São Paulo**  
*Famous gourmet food market in São Paulo, Brazil*



**Investment and Infrastructure** – Investment in general, and specifically infrastructure investment, are key areas of focus in Brazil over the next five years. While on a strong growth path in recent years, investment has softened a bit with 2011's slower growth, and the industrial production data have illustrated that point with three declines in the last five months of data. The industrial production data has impacted the industrial investment side of the equation. Investment overall is still expected to grow faster than consumption in the next few years, and the president of the BNDES (government sponsored infrastructure development bank) expects investment to grow as a percentage of GDP through 2015/2016, growing slightly less than 8% per year – although these forecasts could be conservative, as they were put in place in the heat of the market's decline in 2011.

**Infrastructure investment** is a key component here, and will continue to be a large focus in the next five years and beyond – especially as the country prepares to host the 2014 World Cup (throughout Brazil) and the 2016 Olympics in Rio de Janeiro. Infrastructure investment has increased from US\$34.2B in 2003, to US\$83.7B in 2010 (including US\$30B in BNDES disbursements), and an expected US\$91.4B in 2011 (with US\$30.4B from BNDES). Today, about two-thirds of infrastructure investment comes from the public sector (including BNDES) – although per the BNDES, capital markets will continue to become a more important funding source for infrastructure investment in the coming years, through infrastructure bonds and other sources. From my discussions in Brazil, the base infrastructure components like electricity have improved dramatically in recent years, although is still not where it needs to be. Infrastructure investment seems to be reactive rather than proactive at this point, with investment always trying to catch up with the economic growth. This is another key investment opportunity in the coming years, and the preparation for the World Cup and Olympics could be significant drivers.

**China impact** – Brazil and China are clearly linked at this point – largely because China is the world's largest consumer of numerous commodities. Vale, Brazil's immense iron ore producer, derives about 35% of its total revenue from China, and 54% from Asia overall. As China continues to be the largest fast-growing economy in the world, China's importance is likely to only increase going forward. Thirty-two percent of China's 2010 imports were raw materials, which also illustrates this commodity demand point. As Brazil exports lots of commodities, raw materials, food, energy, etc., the China factor will continue to be key for Brazilian equities, and investors are sensitive to the link.

**Banking industry** – Brazilian banks are in solid shape, especially when considering their developed-world counterparts. The Brazilian banks don't have exposure to the toxic assets plaguing the European and US banks, and the fundamentals are mostly sound at this point. As part of the government's tightening actions, reserve requirements have also increased for the banks – although this could reverse with the central bank's current easing bias. While loan growth has been running in the 15-20% range in recent years, expectations are for 15% over the next few years, which when considering 10% nominal GDP growth (~4% GDP plus ~6% inflation), only equates to 5% REAL credit growth – which appears very reasonable. Many people in Brazil are using financial services for the first time, driven by the massive increase in the middle class population, wage and income increases.

View of Rio de Janeiro  
from Pão de Açúcar (Sugarloaf Mountain)



Cabot Money Management, Inc. is a wealth management firm based in Salem, MA, with additional office space in Boston. As a firm with more than 25 years of experience, Cabot has a national clientele and is a frequent contributor to CNBC, Bloomberg, The Wall Street Journal, The New York Times, and other local, national and international media. Cabot provides highly customized global investment management services coupled with tax, estate and financial advice for individuals and their families.

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**Consumption and Retail Sales** – Consumption is growing faster than GDP in Brazil, with expectations (Morgan Stanley estimates) of 4.0%-4.5% domestic consumption growth in 2012 on 3.5% GDP growth. Retail sales grew 10.9% (real...14.5% nominal) in 2010, and are expected to grow at about 7% in 2011, with expectations for similar growth in 2012. With incomes growing and record employment, coupled with sizable investment and GDP growth in the coming years, Brazil should continue to become an important domestic consumption story, driving imports, retailers, autos, food and beverage, and a range of other key sectors of the economy going forward. I expect retail to be an excellent investment opportunity in the coming years, based on the growing domestic consumption demographics.

**Education is an issue in Brazil.** Multiple speakers at the conference I attended spoke of ill-trained teachers, and the relatively low priority Brazilians have historically put on education. Teaching is at the low end of desired occupations by surveyed university students. The good news is that Brazil is now focused on the issue -- although putting the right incentives in place is the challenge. As more and more people climb into the middle and upper middle classes, education will continue to grow in importance.

### Conclusion

Brazil is in a very unique position among its emerging markets peers. Brazil's vast natural resources, coupled with a large, upwardly mobile population, and a government supportive of growth and a strong economy, could yield very attractive results for those who choose to invest. We believe there are a number of areas of the Brazilian economy that could be profitable investment opportunities. These include:

1. **Consumer staples** – Food and beverage are more defensive, yet still fast-growing, long-term plays on growing domestic consumption and global demand.
2. **Banks** – Excellent ways to play expanding middle class and growing investment. Stocks have been hit, but could be interesting investments as growth resumes and tightening measures shift to easing.
3. **Energy** – Big oil and gas exploration and production operations are underway in Brazil, and there are a few ways to play it
4. **Retail / Consumer Discretionary** – Retail spending should continue to be an excellent growth opportunity, especially as GDP growth reaccelerates.
5. **Homebuilders** – opportunity for growth as middle class expansion drives demand for housing.
6. **Commodities / Metals & Mining** – Global commodity boom driving demand for Brazil's resources.

As the emerging markets economies remain on strong growth trajectories in the coming years, we believe investors will be rewarded. My trip to Brazil strengthens the viewpoint that Brazil will be a strong participant in this emerging markets opportunity for years to come.