BNY MELLON
ASSET MANAGEMENT

Rogerio Poppe
Portfolio Manager
BNY Mellon ARX

BNY Mellon ARX is based in Rio de Janeiro and specialises in Brazilian multi-strategy, equity long short, equity long only and fixed income investment strategies. BNY Mellon ARX provides access to the expanding investment opportunities in the rapidly growing Brazilian marketplace.

BNY MELLON
ARX

Latin giant looks stronger than ever

Growth in Brazil continues to surprise, increasing inflation risks for the year ahead. The second quarter GDP report contained stronger-than-expected headline growth of 8.0% quarter on quarter, with accelerating consumption, continued destocking, and investment bottoming out. Furthermore, the fundamentals driving consumption seem to be improving, with formal job creation back to the pre-crisis pace, and expanding bank credit.

We believe that there are two important factors at play. First, unemployment has been at 7.8% since June, the same level as this period last year and we are already seeing a recovery in total employment, especially among industrial employers.

Second, bank credit is expanding firmly, supported by the expansion of state owned banks' balance sheets that are already as large as those of local private banks. Indeed, the market share of public banks increased to 40.4% of the total credit market in August, only a breath behind local private banks with a 40.6% share. The initially cautious stance of private banks earlier this year was based on expectations of increasing delinquency rates, but the combination of an earlier than anticipated decline in delinquency rates, and the rapid increase of public banks' market share, should make local private banks accelerate credit concessions in the coming months, providing more stimulus for domestic demand.

Rising expectations

Against this backdrop, in September we revised the 2009 GDP forecast to 0.4% (from 0%), and the 2010 projection to 6% (from 5%). Although inflation is currently running below the midpoint target of 4.7%, we and the market are raising our 2010 forecast. We expect consumer price inflation to be at 4.5% next year, boosted in part by the appreciation of the Brazilian real. However, the risks are clearly to the upside.

We expect to see monetary policy returning to more normal levels in the second or third quarter of 2010. The Brazilian central bank's monetary policy committee (COPOM) ended its easing cycle with the policy interest rate at 8.75%, after having cut rates by 500 basis points since January. With the level of economic slack declining faster than anticipated, we are penciling in a monetary policy tightening in 2010. However, we believe that a combination of presidential elections in October, and the absence of formal central bank autonomy may prevent such increases in the near term.

The main risk of a failure to hike interest rates, in our opinion, is that the lagging effect of stimulus from monetary and fiscal actions already taken could impact an economy that is nearer to full employment than our scenario currently projects, thereby adding to inflationary pressures.

Central issue

A further problem is the lack of clarity surrounding the future leadership of the central bank. The current governor, Henrique Meirelles, has recently joined the Democratic Movement Party (known as PMDB) Brazil's largest political party. Despite the excellent track record of the monetary authority in isolating rate decisions from political pressures, the possibility of having Meirelles conducting the next four or five monetary policy committee meetings while nursing political ambitions has raised questions about the central bank's autonomy and is already affecting the pricing of the local yield curve.

Elsewhere, Brazil's balance of payments continues to portray a supportive scenario for the Brazilian real, with a relatively modest current account deficit and large capital inflows. The current account deficit stood at 1.3% of GDP over the year to the end of October and, despite the expected above trend growth in the second half of 2009, we believe the year-end figure will be around 1.5% of GDP, or approximately US$23 billion.

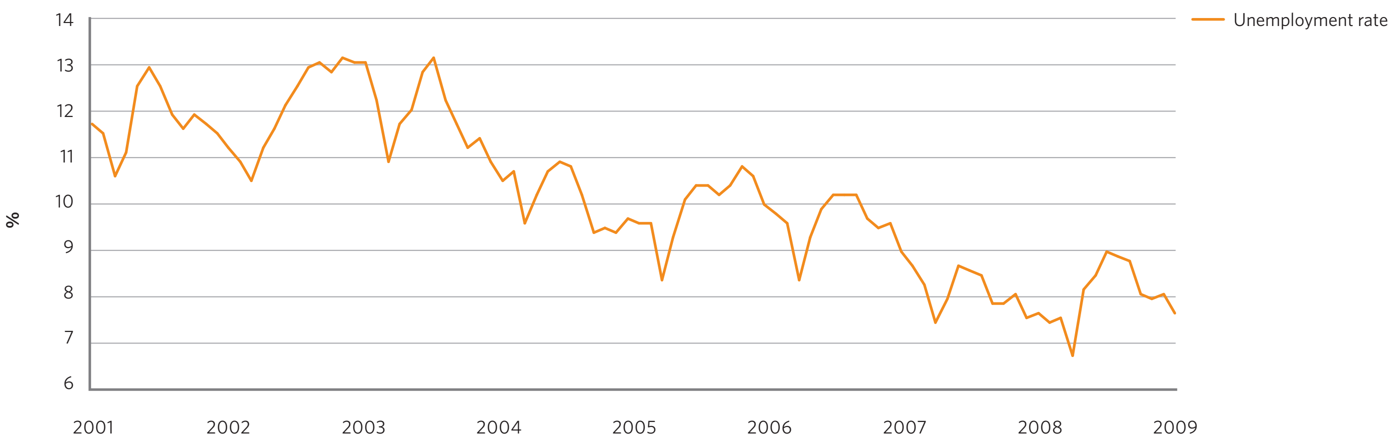
On the capital account, the positive highlights are the portfolio inflows and strong foreign direct investment. Portfolio investments totaled US$40 billion in the first 10 months of the year, compared to US$9 billion for the same period in 2008.

Bedrock assets

While growth related capital inflows are certainly supporting the real's strength, it is worth highlighting that commodity prices (a key driver of the currency) are lagging behind. With more than half of the country's exports related to commodities, the real's performance has been closely associated with commodity prices, but in recent months the real has continued to appreciate against the US dollar, even though the prices of most commodities had stalled. Our assessment is that the perception of above trend growth is attracting massive portfolio and foreign direct investment inflows, which is affecting the selling of the US dollar in the futures market, and supporting the gains of the real.

While we expect Brazil's growth to outperform its peers in coming quarters, we view continued appreciation of the real ahead of commodity price gains with a sense of unease. In fact, either commodity prices will start to benefit from the recent bout of US dollar weakness, or the real's appreciation may eventually be halted by some frustration with capital inflows in the spot market.

BRAZILIAN UNEMPLOYMENT RATE



Source: Datastream as at 30 Sept 2009

www.bnymellonam.com