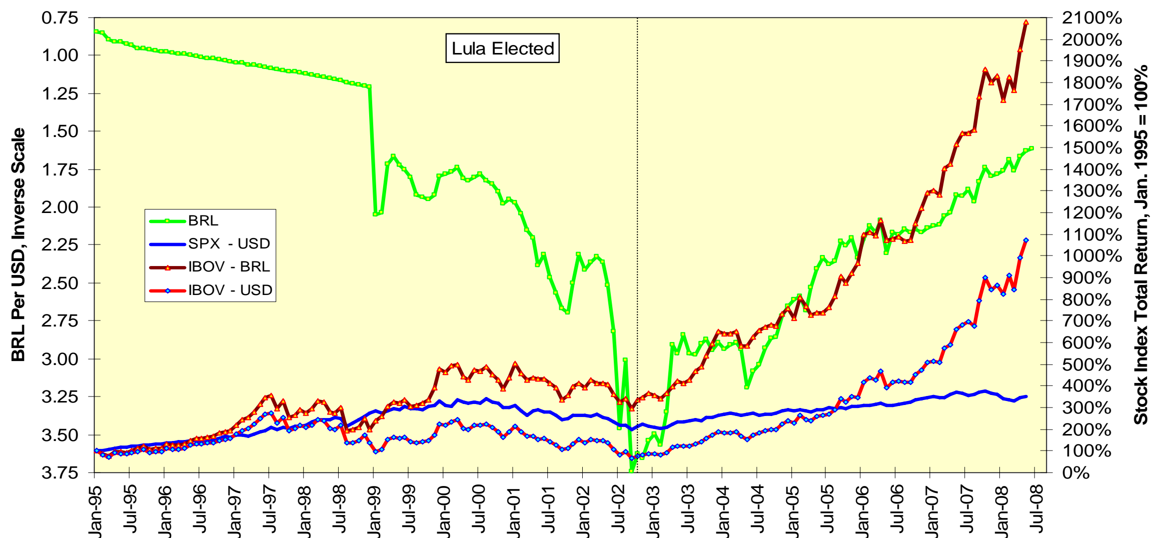
Will Brazil Thrill Still?

Perhaps you, like me, have been getting all sorts of e-mails ranging from inappropriate to offensive about our impending election. Well let's say the worst fears expressed therein come true, just as they did in Brazil in October 2002 with the election of the avowedly leftist Luiz Inácio Lula da Silva. Would you trade our stock market returns since then for Brazil's, and if you would, why?

Brazil's Bovespa index, whether expressed in terms of the dollar or the Brazilian real (BRL), has run rings around the S&P 500 since that time. It has been embarrassing, really, especially for those of us whose memory extends back to the January 12, 1999 devaluation of the BRL, which in retrospect was the final development in the financial crisis that began in Thailand in July 1997. Even the BRL, which did come into its present form until October 1994 and which succeeded a series of failed currencies such as the cruzeiro, cruzeiro novo, cruzado and cruzado novo, has demolished the greenback since Lula's ascension.



Brazil became part of the BRIC quartet, along with Russia, India and China. For those whose thought processes seldom extend beyond acronyms, this has been a rough year for half of the BRICs. While Brazil has gained 15.4% in 2008 in USD terms, and Russia 5.1%, India has lost close to 30% and China more than 40%.

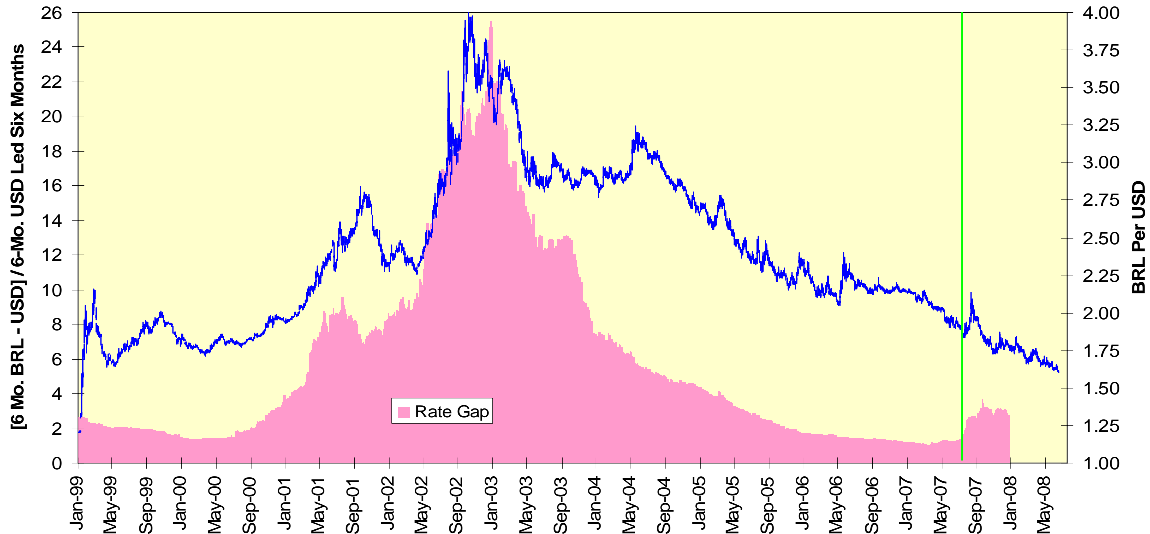
What has been behind Brazil's success and, more important, what are the prospects for continuation? Part of the answer, given right up front, is Brazil has been a beneficiary of the dollar carry trade discussed here in January. That's right, dollar carry trade as opposed to yen carry trade. Our artificially low interest rates are financing other markets, Brazil's included, and that presents both a short-term gain and a long-term risk for Brazil.

Rule Out Rate Gap

The short-term interest rate gap between two countries often is a good place to start any currency analysis, but in the BRL's case, the effect has been opposite the expected answer. Changes in the currency have led the normalized interest rate gap between six-month USD and BRL swap rates by six months. This is the gap between BRL and USD rates divided by USD rates.

As the BRL has strengthened, short-term interest rates in Brazil have been able to fall relative to those in the U.S. If this seems to be a virtuous cycle, it is. Funny things happen to countries with responsible monetary policies. Come to think of it, funny things happen to countries with irresponsible monetary policies, too.

Short-Term Rate Gap Rose During Credit Crunch

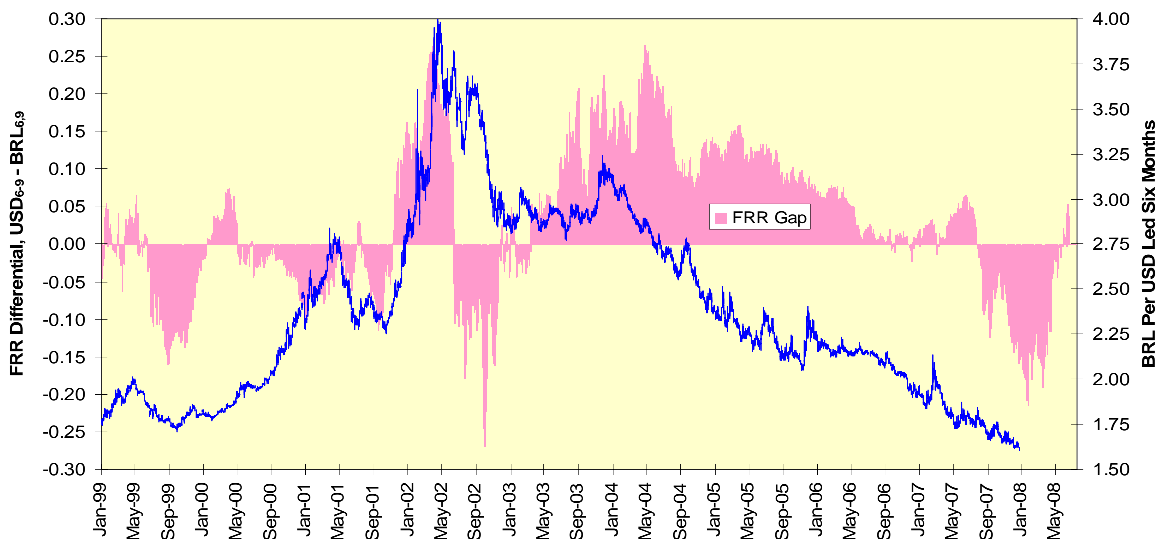


Interest Rate Expectations

What if we move from a simple normalized rate gap to comparing forward curves in the money market? We can measure short-term interest rate expectations by the forward rate ratio (FRR) between six and nine months for both currencies. This is the rate at which we can borrow for three months starting six months from now, divided by the nine-month rate. This measure provides us with a measure of money market conditions expected to prevail when the standard three-month non-deliverable forward is unwound. A FRR in excess of 1.00 indicates a positively sloped money market curve; a FRR less than 1.00 indicates an inverted money market curve.

If we subtract the Brazilian FRR from the American one, we can see how the long trend of rising interest rate expectations for Brazil relative to the U.S. has ended quite abruptly in recent weeks. A little bit of tough-talking by the Federal Reserve has led the market to believe U.S. interest rates will start to rise faster than Brazilian rates starting as soon as next month. As the FRR differential leads the currency by six months on average, this suggests the BRL will start to retreat soon. This, incidentally, is similar to the conclusion reached for the euro last week.

Interest Rate Expectations For U.S. Rising Relative To Brazil



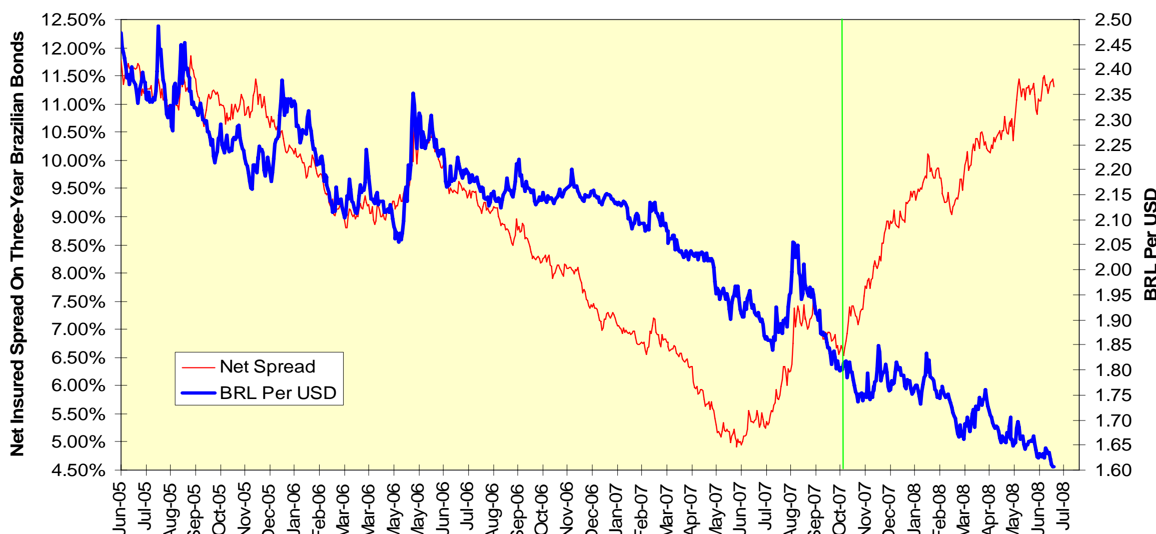
Risk And Return

Now let's add some risk measures into the mix, such as a measure of the insured returns on Brazilian government debt. We can calculate this at the three-year horizon by taking the spread on Brazilian notes over U.S. notes and subtracting the cost of a three-year credit default swap (CDS) from this raw spread. A CDS acts like a put option on a bond; the buyer of a CDS surrenders basis points of yield to a CDS writer in exchange for a promise to deliver the

underlying bond at par or a cash equivalent in the event of a default or other stipulated credit event such as a material downgrade. The riskier the bond, the greater the insurance cost.

While the normalized six-month yield gap between Brazil and the U.S. has been narrowing, look at how the insured credit spread has been widening since the onset of the credit crunch last year. If we go back to October 2007, the peak in the U.S. stock market and the time when China acquiesced to an accelerated revaluation of the yuan, marked with a green line on the chart, we see how the insured credit spread between Brazil and the U.S. has exploded higher.

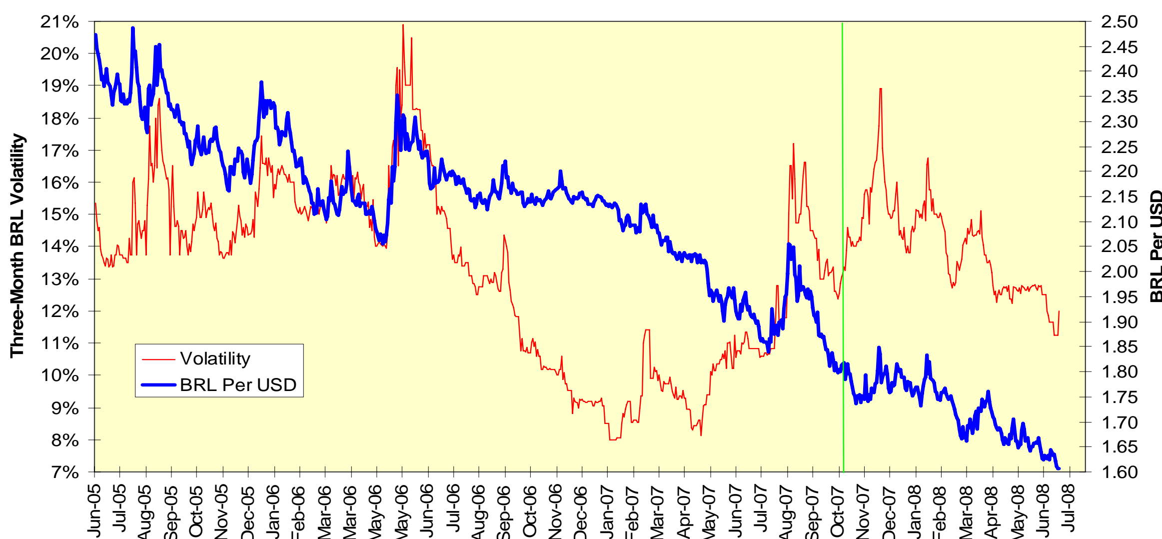
Real Rose As Spreads Widened



What is going on here? A simple answer is the strong Brazilian economy can afford to outbid U.S. borrowers for U.S. funds. The higher yield in Brazil at this capital market horizon is pulling capital from the U.S. The conversion of those dollars into reais has been driving the exchange rate. This is the dollar carry trade in action.

Finally, let's add the second measure of market anxiety, the volatility on three-month BRL forwards for a holder of dollars. Once again, if we look at the rally since last October, we see declining demand for insurance even as the BRL has firmed. The market accepts the rally, and that is bullish with a capital "B."

Real Volatility Has Fallen During Rally



What can derail the Brazilian market? If Brazil has been financed by American monetary profligacy, then removal of that profligacy can end the dollar carry trade and produce as much indigestion as did Japan's furtive efforts to end the yen carry trade in 2006.

The trade is simple: If you believe the Federal Reserve will maintain its policy of keeping the real federal funds rate negative, stay long Brazil using an instrument such as the iShares MSCI Brazil ETF. If you believe they will tighten, sell any funds you may have with a Latin American focus.