# Brazil Bullish Still

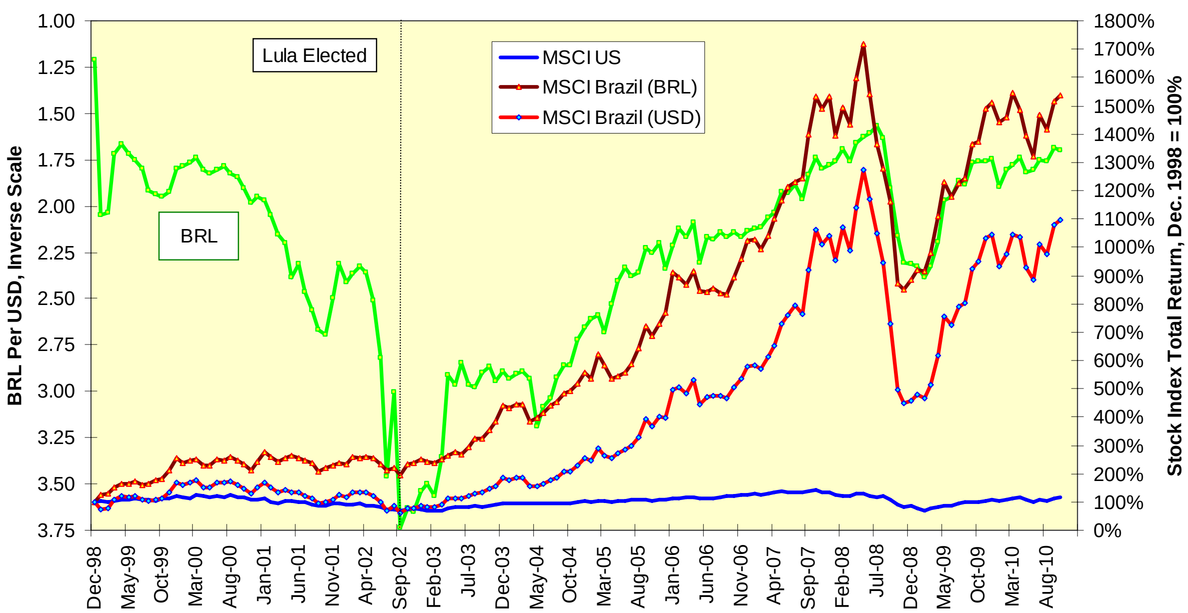
Will we enter an era when foreign countries start posting armed guards at their borders, both real and virtual, to keep American dollars out? This is not an idle consideration given the number of countries, Brazil included, imposing various forms of capital controls, taxes and penalties on the earnings of foreign investors.

When the Federal Reserve began lowering interest rates in 2001, it aimed its missiles at the American consumer and hit the Chinese producer instead: Yes, Americans consumed more, but an increasing share of that consumption was met by lower-cost Asian exporters. Now the Federal Reserve is aiming its missiles at the American investor – Ben Bernanke finally admitted he was targeting a wealth effect from stocks – but they are just as likely to hit foreign asset prices first through the mechanisms of the dollar carry trade.

**Some Pain, Big Gain**

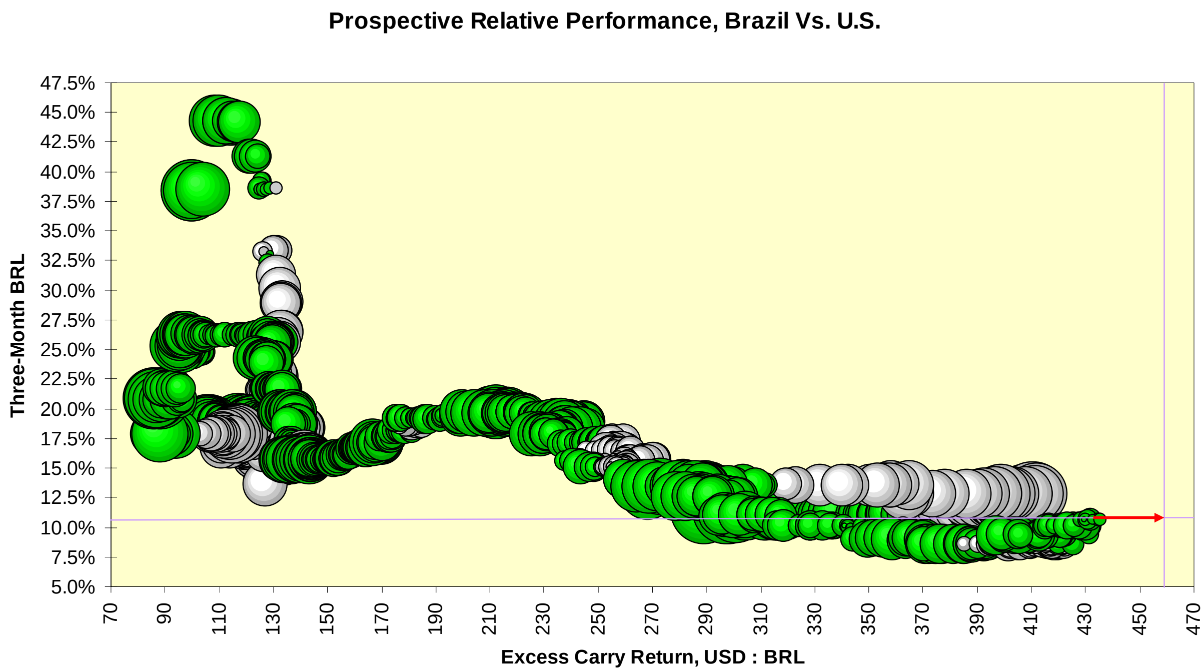
When the Brazilian real (BRL) fell sharply in January 1999, in what was the last episode of the Asian/Russian/LTCM rolling crisis from July 1997 onwards, I thought, "This cannot be ignored. Brazil is the eighth largest economy in the world." Indeed, the BRL continued to fall into the 2002 election of Lula da Silva, an avowed socialist and former labor leader who then proceeded to preside over one of the great economic transformations, for the better, of our era. Not only did the BRL recover, but Brazilian equities have outperformed American ones in both BRL and USD terms to an almost embarrassing extent.

**The Real And Comparative Equity Total Returns**




As the newly elected Dilma Rousseff has a similar left-wing background and realizes she has to act in a fiscally responsible manner to maintain markets' trust, we should expect Brazilian growth and Brazilian interest rates to remain high relative to their American counterparts. That is for starters; Brazil may have to nudge rates higher as Australia and China have had to do to counterbalance the effects of manic dollar-creation. As they have to accept USD, the world's reserve currency, their asset prices and their money supply will grow unless they sell bonds to soak up money as fast as the U.S. creates it, and good luck with that.

What will this mean for Brazilian equities, including the readily accessible iShares MSCI Brazil ETF? If we map three month-ahead relative performance of Brazil vis-à-vis the U.S. as a function of the excess carry return of borrowing USD and lending BRL and Brazilian three-month rates, we see prospective returns are poised to increase. Brazilian outperformance is depicted in green bubbles, American outperformance in white bubbles with the diameter of the bubble corresponding to the absolute magnitude of the relative return. Current readings are noted in the bombsight, and a red arrow connects the three month-ago point to today.




As U.S. rates are going to remain low and the pressure on Brazilian rates is higher, the carry return will expand and takes stocks along for the ride.  Unless, of course, Brazil and other emerging market highfliers start to freak and threaten to deport the next international portfolio manager who lands in São Paulo.  They might: After all, the more fiscally responsible Brazil is, the greater the interest rate gap will be and the more newly created USD will seek a home in Rio.