Brazil Approaching Attractive Valuations

One of the more unusual conceits of the past year is the jaw-flapping about tapering QE starting in May 2013 somehow caused the downturns in emerging markets such as Brazil; this market hit its post-crisis peak in April 2011 in USD terms and in November 2010 in BRL terms. The one redeeming feature of bad market analysis is how it opens us up to the exciting world of time-travel.

Remember all of the hyperventilating about BRIC markets and, more important, all of the various investment schemes launched for you to take advantage of this easy-to-remember acronym? My *Bloomberg* search for BRIC exchange-traded securities, all countries, turned up 575 results. Well, if we go back to the November 2010 launch of QE2, the U.S. has gained 60.5%; the BRIC quarter in their B-R-I-C order have returned -39.3%, -7.6%, -30.6% and -8.9%, respectively. Themes are best left to party-planners, not to investment managers.

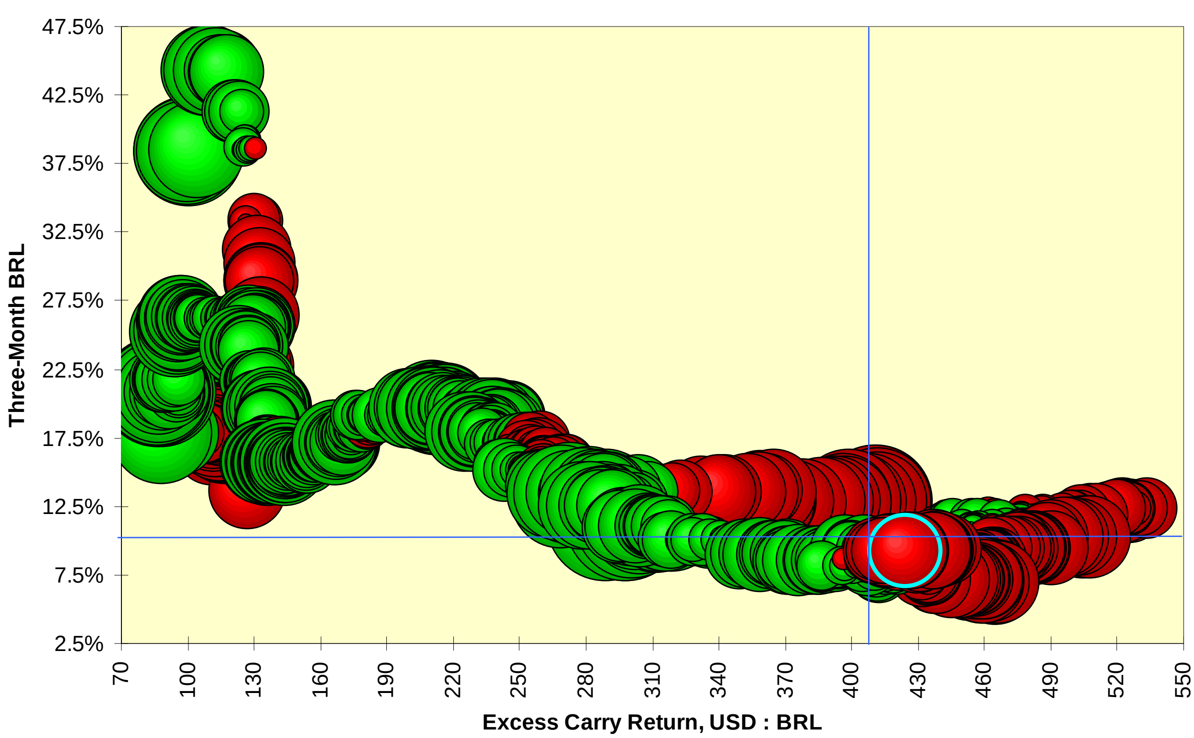
Buy Low, Sell High

If you buy a Brazilian fund such as the iShares MSCI Brazil ETF (EWZ) you are assuming the currency risk. This has not been a good bet since July 2011 as the carry return for swapping your dollars for their reais has been -17.7%. Once again, do not blame it on the Federal Reserve; blame it on Rio.

This negative carry into the BRL is likely to persist for the next three months at least given expected short-term interest rate differentials between the U.S. and Brazil. The U.S. short-term swap curve between six and nine months has been flattening relative to Brazil's swap curve; this means loans into the BRL will roll down the yield curve faster. In addition, the absolute rate gap at six months has pushed out to the highest levels since the BRL's January 1999 devaluation; any narrowing of this gap will reduce yield hogs' incentive to lend into the BRL.

That bad news is known. The good news is such a decline in the BRL will make Brazilian assets cheaper for USD-domiciled investors. If we map three month-ahead Brazilian relative performance vis-à-vis the U.S. as a function of the excess carry return into the BRL and three-month Brazilian rates, we see how a continued decline in the BRL will push relative performance into a zone of green bubbles. Red bubbles denote U.S. outperformance; the diameter of the bubbles corresponds to the absolute magnitude of the relative performance. The last datum used is highlighted with a turquoise ring; the current environment is marked with a bombsight.

Prospective Relative Performance, Brazil Vs. U.S.



Brazil has two excellent lessons on its borders in Venezuela and Argentina of what not to do in a resource-rich economy. Both should be rich countries given their endowments; both are messes given their long history of socialism and populism. Countries that fall into the trap of worrying about redistributing wealth, expropriating entrepreneurs and substituting whim for rule of law seldom emerge intact. This is a lesson with more universal application.