

31st of March 2011

Economic Analysis of Brazil Q1 2011

CONTACT:

Exact Invest Ltd.

info@exactinvest.dk

+45 70 22 87 77

Research & Analysis

Søren Møller-Larsson

sml@exactinvest.dk

INFORMATION:

www.exactinvest.com

Summary:

- As expected, the GDP-growth of Brazil reached with 7.5% the highest grow rate in almost 25 years. The State of Ceará registered an impressive 7.9% growth, surpassing Brazil's mean growth for the third year in a row.
- In 2010, the retail sales rose by 10.95%, which is also a new record. The air traffic of Brazil rose by 21.3% in 2010.
- The unemployment rate was at its lowest levels ever in 5 consecutive months in 2010. In December, it plunged to 5.3%, and in all of 2010, 2.56 million new jobs was created in Brazil.
- The inflation index, IPCA, climbed to just above 6% p.a. When global food prices rise, the IPCA- index is also heavily affected.
- In early March, the Central Bank of Brazil increased the interest rate of 0.5 percentage points, pushing the Selic rate to 11.75%. The Brazilian real interest rate of 5.4% remains as one of the highest in the world.

Key indicators:

<u>Facts and consensus expectations</u>	<u>2011</u>	<u>2012</u>
GDP growth	4.5 %	4.5 %
Unemployment rate (10/2010)	6.1 %	-
Public debt (9/2010)	40.1 %	38.0%
Inflation rate (IPCA p.a. end of year)	6.0 %	4.8 %
Interest (SELIC end of year)	11.75%	-
Exchange rate (DKK/BRL, 31/11)	3.15	-
External balance/GDP	-2.29 %	-
INCC Construction Price Index (y/y, 10/2010)	7.52 %	-

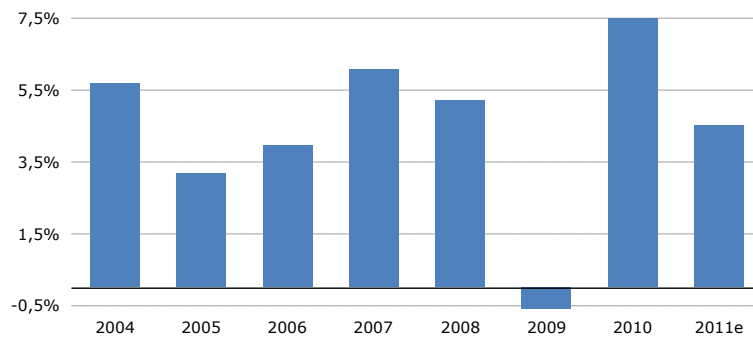
This material may not be reproduced or distributed without permission from Exact Invest Ltd.

GDP

During 2010, the financial crisis was quickly forgotten in Brazil. The GDP-growth of 2010 set a new record. GDP growth of 7.5% is the highest in almost 25 years. The record high growth is primarily generated in the first three quarters as a consequence of the untapped growth potential that emerged after the financial crisis. The last three years, the Brazilian economy has grown 4.1% on average, which is an incredible level considering the financial crisis. Brazil has moved up to be the world's 7th biggest economy, claiming the position that formerly was held by Italy. Next year, the two anterior countries on the list, Great Britain and France can expect competition for the position as the world's 5th largest economy.

Figure 1: GDP growth and expected GDP growth, percent p.a.

Brazil's GDP grew in 2010 by record high 7.5%



Source: Central Bank of Brazil (BCB)

As described in the latest quarterly report, the 4th quarter of 2010 cooled slightly and a 5% growth rate of the quarter points towards a lower and more sustainable growth in the future. This is expected to apply for 2011. In accordance with the trend of the 4th quarter of 2010, the consensus expectations are a growth rate in 2011 of 4.5%.



The economic growth is primarily run by a continuously strong domestic demand, which again is caused by a growing purchasing power of the middle class. The trade surplus was falling during most of 2010 because of increases in imports, stimulated by a strong Brazilian currency. Since November, the export has grown faster than the import, prompting a change of the tendency in the trade surplus. In February, the accumulated yearly increase in exports amounted to 33.9% while imports increased 42%.

The State of Ceará is contributing to the Brazilian growth. Despite a weak agricultural output, Ceará registered an impressive 7.9% GDP-growth in 2010, surpassing the national average for the third year in a row. The construction sector is the state's fastest growing with 14.5%, which Exact Invest A/S certainly notes with some pride. Compared to other parts of Brazil Ceará is from a lower level of development, and the state's average GDP-growth of 6.47% over the three previous years is 58% above Brazil's average growth level. Source: IPECE.

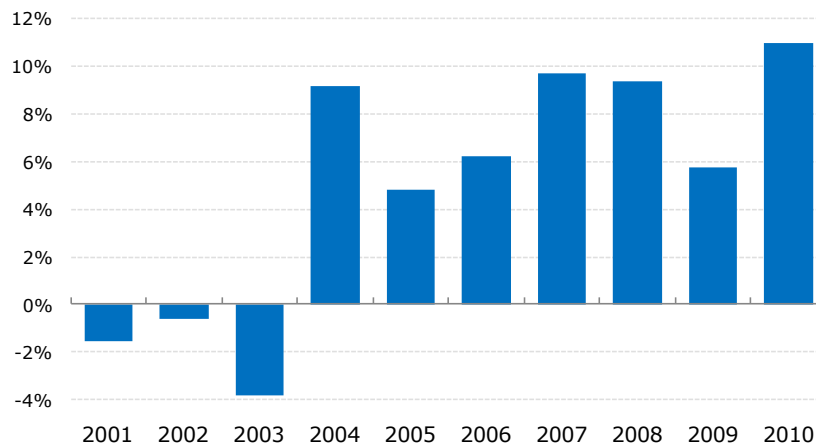
Read about the dynamic investments in Ceará in the article ["Public and Private Investments Support the Economic Growth in Ceará"](#)

A Strong Demand

The strong development in the domestic demand continues. As a result the retail sales grew by no less than 10.95% in 2010. As Figure 2 illustrates, this is the highest increase since the beginning of the index in 2001.

Figure 2: Retail sales p.a., changes in percentages.

The retail business experienced an increase of 10.95 in 2010



Source: IBGE

The retail sales have been increasing rapidly the last seven years, and Exact Invest A/S expects the present expansion in consumption to continue. This is supported by the fact, that the retail sales in January 2011 grew by 8.25% compared to the same month of 2010.

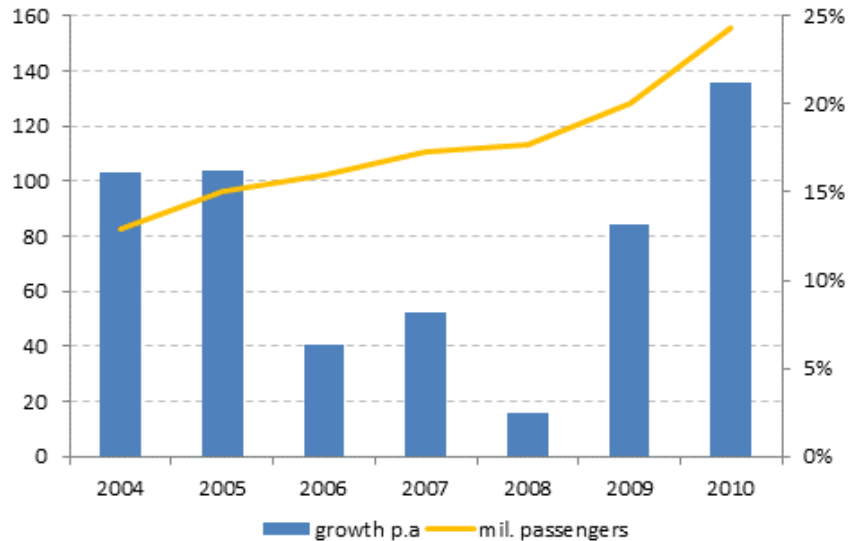
The people of the state of Ceará are certainly not wasting the time. The retail sales rose by 14.78% in 2010. This is the highest increase since 2005.

The air traffic in the big Latin-American country is also affected by the enormous demand. Figure 3 shows the number of passengers as the

number of arrivals and departures in Brazilian airports. With more than 155 million passengers in 2010, the number has almost doubled since 2004.

Figure 3: Air passengers, numbers in millions. Growth in number of passengers, in percentages.

In Brazil, 155 million air travellers were registered in 2010.



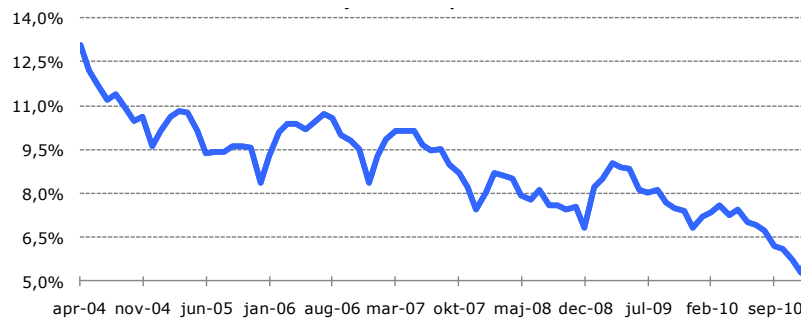
Source: Infraero

Figure 3 also shows that the Brazilian air traffic grew by 21.3% in 2010. It is primarily the domestic demand that is fuelling activity level. The fact that 90% of Brazilian air travelers chose domestic flights is further support for this perspective.



Unemployment and capacity utilization

For no less than five consecutive months has the unemployment rate set new record lows in 2010. As shown in Figure 4, the last months in the year are usually experiencing the lowest levels of unemployment. This is due to seasonal dependent jobs. The formal unemployment rate in December 2010 fell to 5.3%, which is 1.5 percentage points lower than any previous observation for that month. In 2010, the average unemployment rate was only 6.7%, which is also by far a new record low for a single year.

Figure 4: Unemployment in percentages

Source: IBGE

The unemployment rate in 2010 reached a new lowest level for five months in a row. In December, it was at 5.3%

The expected rise in January in unemployment to 6.1% is still more than one percentage point lower than the same month in 2010.

In 2010, 2.56 million new jobs were created in Brazil, and these figures do also exceed the expectations. The Brazilian Ministry of Employment announced that the country in February created more than 280,000 new jobs. This number corresponds to a pick-up of 35% compared to January in 2010. In this context, it is worth remembering that the official statistics does not include the many Brazilians who work without formal documentation.

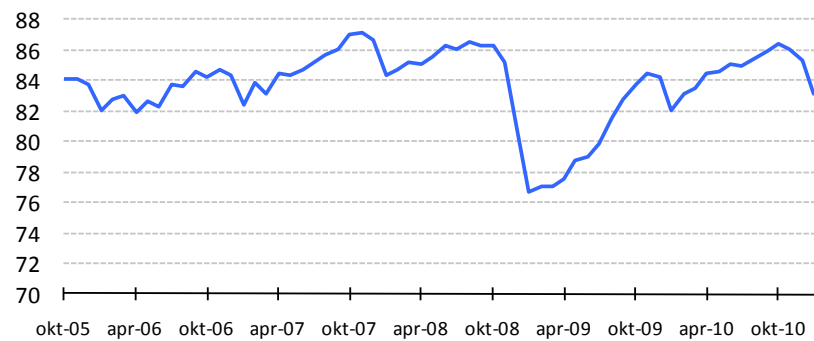
The Brazilians are young; a great part has just become part of the labour force or is about to enter the labour market. More than 50% of the population has not yet turned 30 years old and within the next 20 years the labour force is expected to grow by more than 18 million people.



The historically low unemployment rate might potentially stress the product supply, since businesses might have a hard time finding qualified workers. This might ultimately lead to increases in consumer prices (consequently in inflation) in periods with high demand. It is, however, worth noticing that the capacity utilization, after having topped with 86.4% in October 2010, has dropped during the last couple of months to 83.7% in February 2011. On a seasonal basis the February-level is still relatively high.

The strain to the capacity utilisation has eased off. In February it was at 83.7%

Figure 5: Capacity utilization in percent



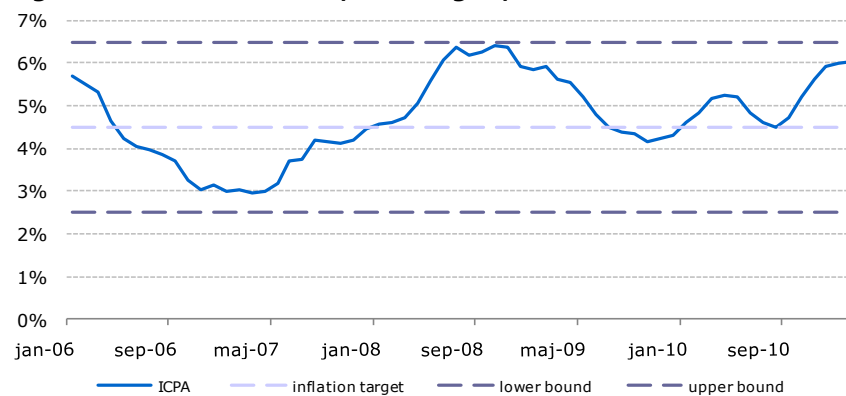
Source: FGV (Fundacao Getulio Vargas)

A decrease in the capital utilization, a slight slowdown of the economy, and strong investments is contributing to support the impressive low unemployment rate, and might, to some extent, for now ease the pressure on the economy. Investments are still very important for this progress to continue. That the export is growing faster than the import can also be an indicator of a slight easing of the pressure on domestic supply.

Increased Pressure on Inflation

After previous months with increasing inflation, it seems that the strength of inflation is about to ease off. The once-a-year adjustment of the price of education forms 50% of the inflation in February, which by 0.8% m/m is lower than the expectations. This means, that the IPCA inflation index has only just reached 6% p.a. The inflation is thus above the Central Bank's target of 4.5% p.a., but still within the acceptable margin of +/- 2%. Figures from the IPCA published every second week shows signals of a further decrease of inflation.

Figure 6: Inflation – IPCA, percentages p.a.



Source BCB and IBGE

Inflationen i februar måles til 6,01% p/a

In the latest quarterly report we described how the banks' capital reserve requirements were raised in an effort to restrain the overall money supply and thus the demand. Despite the strong demand, the higher reserve requirement together with an adjustment of the interest rate suggests that more moderate and healthy price increases is not too far away.

Around the world, the price levels have been increasing in the past 6 months. This is primarily a consequence of global economic disequilibrium

and political instability. In Brazil, the inflation has been squeezed from several sides. A big economy topping and experiencing a huge demand is also significantly influenced by the above mentioned external factors.

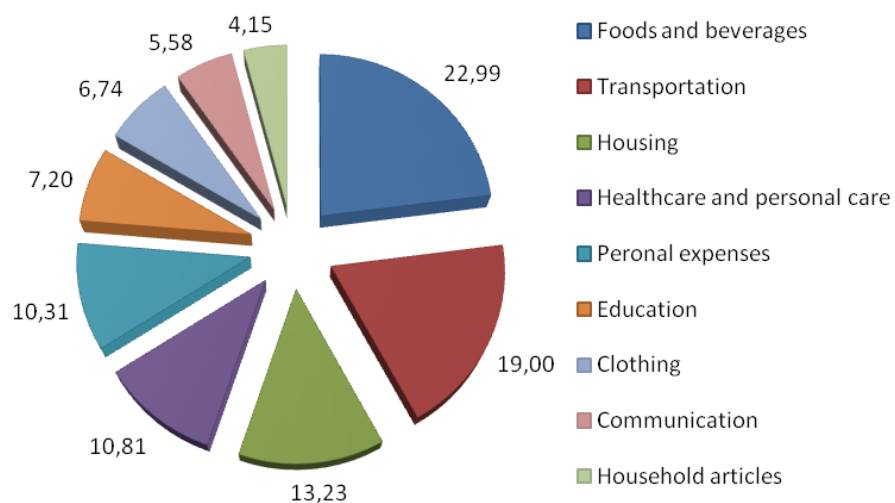
The global commodity prices have increased during the last quarter.



Brazil is a big country with approx. 195 million inhabitants, according to IMF. Big parts of the population should, in spite of increases in socio-economic equality, be regarded as relatively poor with limited resources to just satisfy the most basic needs. This means, that when global food prices rise, the Brazilian inflation index is influenced heavily. Unusually bad conditions regarding the climate, locally and globally, have fuelled the rising food prices.

Figure 7 illustrates the previous year's average weighting of the price categories in the inflation index IPCA. The 'foods and beverages' category makes up more than a fifth of the overall inflation index. An increase of prices in this category would weigh more than twice as much as an equivalent increase in e.g. the 'personal expenses' category.

Figure 7: Weighting of price groups in the IPCA index, in percentages



The Brazilian inflation index is sensitive as to price increases of foods and fuels.

Source: IBGE

The instability in North Africa and the Middle East has added to the rising fuel prices, and that is why the equally heavy category of 'transportation'

is also highly influenced. Both in December and January price increases in these two heavy categories made up 60-70% of the total price increases.

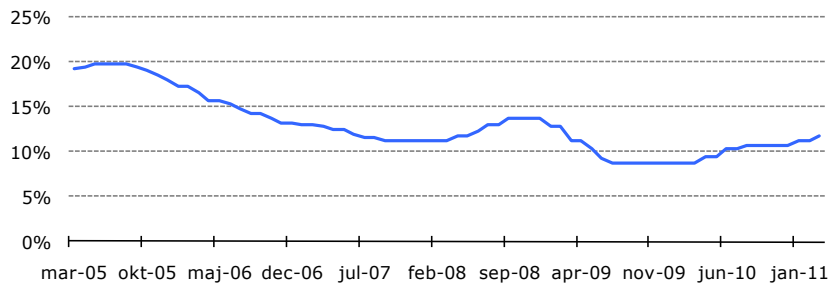
As already stated, the inflation in February was lower than expected, and it's important to observe that the price increases in the two heavy categories have eased off considerably. Thus together, the two represents only around 20% of the total price increase of the February.

As one of the world's biggest exporters of commodities, Brazil's export value has been influenced positively by the global price increases.

The Brazilian Interest Rate

At a high pace has the Brazilian economy recovered from the crisis, which was partly due to the stimuli from a relatively low interest rate. The demand and increasing inflation has made the Central Bank - like in most other emerging markets - raise the interest rate in order to adapt the economy to the post crisis level.

Figure 8: The selic rate, percentages p.a.



The leading Selic rate was raise in March to 11.5%

Source: BCB

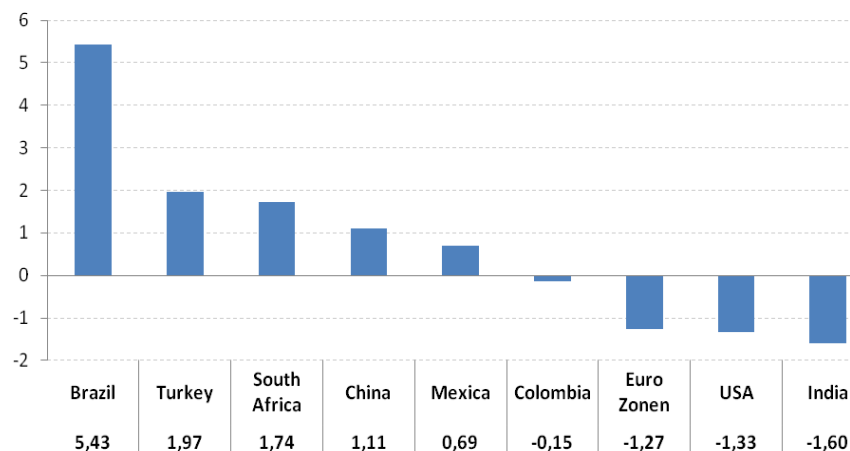
In the beginning of March, the Brazilian Central Bank raised the interest rate by 0.5 percentage points, moving it to 11.75%. Since the deployment of new central bank director, Alexandre Tombini, in January, the interest rate has been raised twice in a row from 10.75%, as a response to the rising inflation. With the adjustments in the interest rate, Tombini proves himself to be closely monitoring the evolution of the inflation.

The Central Bank being dedicated to fight the inflation is also indicated by the level of the real interest rate. The immediate interest rate in Brazil of 5.4 % is continuing to be one of the world's highest, only exceeded by Croatia's. Figure 9 below shows that similar emerging markets and developing countries have remarkably lower real interest rates than that of Brazil.

Kenneth Rogoff, professor of Harvard University says to FT.com:

"Brazil ought to have real interest rates half of what they are and I don't think you'd need a PhD in economics to see that over the long run, that would be a huge boost to investments growth"

Figure 9: Real interest rates in similar countries, in percentages p.a.



Source: Each country's central bank.

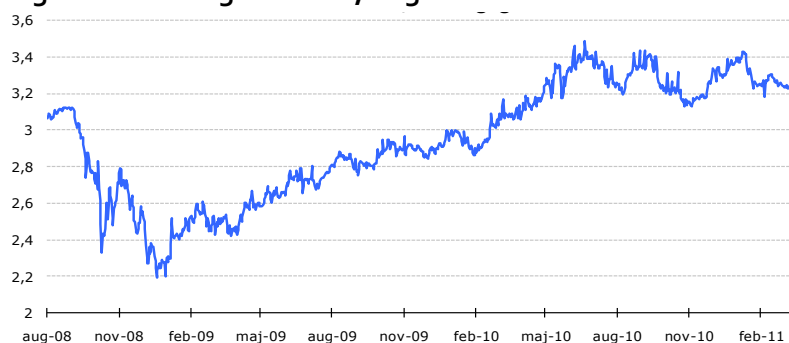
On a long term basis, Exact Invest A/S still expects the interest rate to decrease as the Brazilian economy matures.

Currency

The Brazilian currency is continuing to be in a strong position in the market and the BRL has been in focus over a longer period of time. The Central Bank has chosen to protect the BRL against further appreciation by stepping up interventions in the currency market. As a result, the Central Bank's currency reserve has grown due to the purchases of primarily USD.

As shown in figure 10, the BRL has been stable against the DKK. As of the 24th of March, one BRL costs 3.15 DKK, which corresponds to a modest increase in value of 1.6% compared to the same day in 2010.

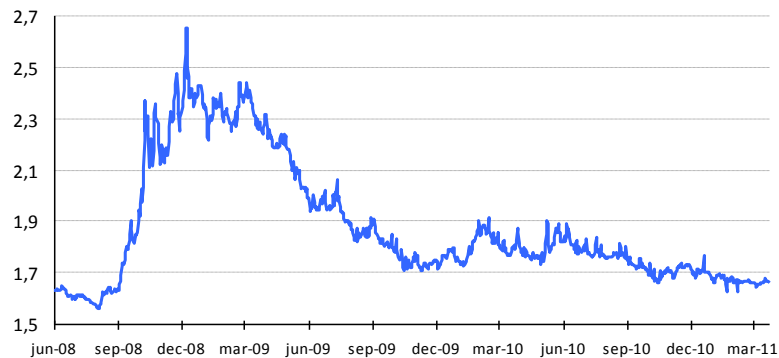
Figure 10: DKK against BRL, August 2008 – March 2011



Source: Oanda

Upon a strong return from the crisis, the BRL has – as shown in figure 11 - gradually gained value against the USD during the previous year. As of the 24th of March, USD costs 1.66 BRL, just above the 1.65 considered to be the Central Bank's unofficial lower limit, and still above the levels just before the financial crisis. This corresponds to a 7.4% appreciation of the BRL compared to the same day in 2010.

The BRL has increased its value in the last year. Right now, one USD costs 1.66 BRL

Figure 11: BRL against USD, June 2008 – March 2011

Source: Oanda

In October, Brazilian authorities raised the IOF tax on foreign investments in Brazilian shares and bonds to 6%. The tax increase has since considerably reduced the inflows of foreign investments in Brazilian stocks and fixed income securities. In January 2011, only 206 million USD entered Brazil, whereas a whole 16.3 billion USD entered Brazil in October 2010.

The changes in taxation do not affect the foreign direct investments (FDI), which is the kind of investments Exact Invest A/S is engaged in. In 2010, the FDI's in Brazil rose to 48 billion USD, a much higher level than 2009, where 25.9 billion USD entered Brazil as FDI's. Exact Invest expects this positive development in the FDI will continue during 2011.

Figure 12: FDI, million USD

In 2010, FDI's in Brazil almost doubled compared to 2009

Source: Brazil's Central Bank

The previous month's increasing tendency in the trade balance shows that the export does not seem to be affected significantly by the strong Brazilian currency.

The First Months with Dilma

Dilma Rousseff, Brazil's new president has been received positively by the market. A market that, at first, was a bit hesitant towards her political and economic impact. The recent month's accelerating inflation and the strong currency has highlighted the importance of reforms and cuts in spending.

Rousseff has already made some major political decisions, e.g. a cut of the public spending of 30 billion USD in 2011. The objective of the cuts is to dampen a Brazilian economy that, for a longer while, has been operating on the highest level.

At the same time, Rousseff has shown the market that she is able to slow down the high and unhealthy increases of the minimum wages, which became a core element of former president Lula's politics. This reduces the risk that the strong domestic demand will further pressure the already booming economy.

Disclaimer

Exact Invest Ltd. has prepared this analysis. The analysis contains statements on future activities including exchange, interest and market development. These statements are based on the estimates made by Exact Invest Ltd. and therefore involve a number of uncertainties beyond reach of Exact Invest Ltd. Changes in relevant economic conditions and other factors may imply that the conclusions of the analysis may suffer alterations to some extent. The information, calculations, and estimations of the analysis are procured in order that potential investors may form an opinion of possible investments. Exact Invest Ltd. claim no legal responsibility for possible investments made on basis of this analysis.

This material may not be reproduced or distributed without permission from Exact Invest Ltd.