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Economic Analysis - Brazil 3rd Quarter 2011

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RESUMÉ:

- GDP growth slowed in the second quarter and the economy grew 3.1 % y/y less than expected. Thereby, the economy registers 3.6 % y/y growth in the first six months of 2011.
- Debt crisis and troubled financial markets has also weakened the Brazilian Real (BRL), a tendency that has turned around since late September. BRL is traded 3.2 % lower than its average level in 2011 against the Danish Krone (DKK).
- Unemployment remains low at 6 % in August.
- Despite the economic slowdown retail sales deliver great success. In July, the 12-months accumulated retail sales grew 8.5 % y/y.
- In September inflation is 7.23 % p.a., above the central bank's target. It is expected that the upward inflation trend will revert towards target by the end of 2011.
- The overnight lending rate Selic was surprisingly lowered by 0.5 %-point to 12 % p.a. based on a "substantial deterioration" of the world economy.

Key figures

<u>Data and consensus expectations</u>	2011	2012
GDP growth	3,5 %	4,0 %
Unemployment (aug.)	6,0 %	-
Public debt/GDP (aug.)	39,2 %	38,0 %
Inflation (IPCA p.a., aug.)	7,23 %	5,6 %
Interest rate (SELIC p.a. end of year)	12,00 %	-
Exchange rate (DKK/BRL) (10. okt)	3,14	-
External Balance/GDP (aug.)	- 2.07 %	-
INCC construction price index (p.a., aug.)	7,75 %	-

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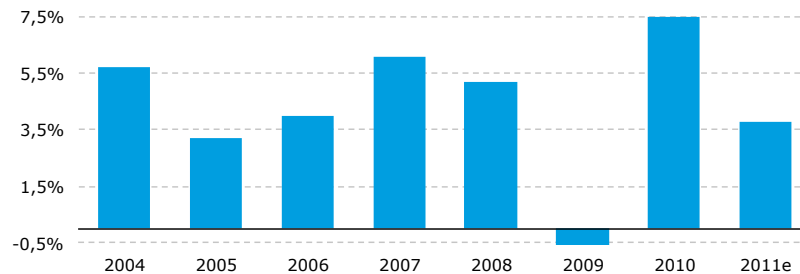
GDP

The prospect of a slowdown of the Brazilian economy in 2011, described in earlier economic analysis, is starting to realize. The world economy has simultaneously evolved in a direction best described as unresolved.

GDP growth slowed in the second quarter and the economy grew 3.1 % y/y less than expected. Thereby, the economy registers 3.6 % y/y growth in the first six months of 2011.

The domestic demand seems to be highly resilient, while it is also the mayor growth engine for the big Latin American country. That development does not seem to end anytime soon, and coupled with a low unemployment the domestic demand will ensure Brazil against even the worst external shocks, in the same way as it did in 08-09.

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



Source: Banco Cetral do Brasil (BCB)

The central bank adjusts the expected GDP growth rate of 2011 to 3.5 % p.a.

Ceará, the state in which Exact Invest A/S has its primary activities, are again making a positive contribution to the national average and is in the second quarter growing 4.4 % above the same period the year before. Thus, the growth rate has not slowed from the first to the second quarter on a year on yeah basis in the state. This means that Ceará GDP grows by 4.4 % during the first half of 2011.

That the Brazilian economy is slowing down can be regarded as healthy due to the fact that the pace of development in Brazil will ease of a bit. While the economy was growing at its fastest pace it was highlighted that the development in the country's structural conditions could not, to the same extent, keep up the pace. Evidence for this was seen in a tight job market and an insatiable demand for investments in additional capacity and improved infrastructure.

The world economic situation meant that BCB in September decided to lower its expectations of GDP growth in 2011 to 3.5 % p.a.

Talks about the Brazilian economy going from boom to overheated has faded away, and in which direction the world economy develops in the near future is difficult to predict. This underlines the importance of forward-looking reform governments and effective central banks - also in Brazil.

Thus, a lower growth will make room for the Brazilian economy to evolve in a more sustainable pace in relation to infrastructural deficiencies and world economic imbalances.



The export returned towards the end of 2010 to the level before the financial crisis and the 12-months accumulated export has since the beginning of 2011 grown with more than 20 %. Meanwhile, the yearly net export has grown every month through 2011 and is at its highest level in nearly three years.

Exchange rate

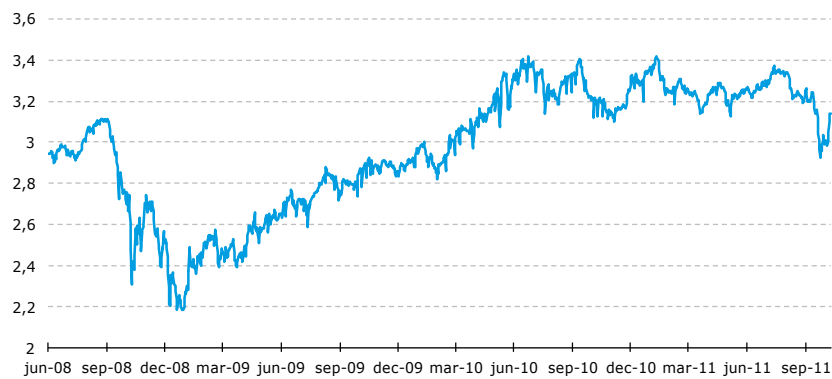
The Brazilian Real (BRL) has advanced into a historically strong and stable position through 2010 and 2011 against both Danish Krone (DKK, fig. 2) and US Dollar (USD, fig. 3). A quick depreciation in September does not change this long-term development. Debt crisis and troubled financial markets has meant that investors in September sold off investments in emerging markets (EM) local currency bonds and equity funds.

Events like that do of course also affect the exchange rates significantly. BRL is also affected, but the Real has recovered well in the last half of September and the beginning of October. An important factor herein is the markets apparent recognition of BCB's recent signal to intervene in situations where BRL shows greater volatility.

The BRL has depreciated 3.5 % against DKK since September 1st. As seen in figure 2 the BRL has recovered well and is traded at 3.14 DKK pr. BRL on October 11th, 3.9 % lower than the average 2011 level and 5.8 % higher than the trading price January 1st 2010.

BRL trades at 3.14 DKK
pr. BRL October 11th.

Fig. 2: DKK pr. BRL June 08 – Oct. 11



Source: Oanda.com

Against the USD the same tendency can be seen in fig. 3. BRL has come back after a sharp depreciation in the beginning of September. Because of the European debt problems and the fact that Brazilian securities is mainly traded in USD the overall weakening against the USD relative to DKK, and BRL has depreciated by 10 % against USD since September 1st. BRL is trading at 1.76 pr. USD on October 11th, which is 7.5 % lower than the average 2011 level and 1.7 % weaker than the trading price January 1st 2010.

Fig. 3: BRL pr. USD June 2008 – Oct. 2011



Source: Oanda.com

BRL is weakened around
10 % against the USD
since September 1st

Local currencies in the EM countries South Korea, Russia, and South Africa are by comparison all weakened 9-13 % against the USD since September 1st.

The weakening of BRL is caused by several factors. The Brazilian currency has for a prolonged period been in a strong position against the world's leading currencies, and the country has for a long time been recipient of large amounts of liquidity. BRL is supported by Brazil's diversified production facility, its natural resources, one of the world's largest real interest rates, the global imbalances, and the high commodity and food prices. When analyzing the weakening of the BRL it therefore also important to take into consideration the prospects for lower oil and food prices and the surprise interest rate cut in late August. Despite the uncertainty in the financial markets a part of the depreciation must be regarded as an adjustment of the BRL to the expected commodity price level.

As can be seen in the graphs above, the flight from BRL are not nearly as dramatic as earlier indicating that investments in the Brazilian currency is regarded as far less risky as earlier. This is also supported by Fitch's and Moody's credit ratings upgrades in the spring.

Large amounts of foreign direct investment (FDI) continues to flow into Brazil, in August meaning that total FDI reaches 44 billion USD in the first three quarters of 2011. Thereby, looking to surpass the 44 billion USD the country received in the record year 2010. FDI is the kind of investment Exact Invest A/S is involved in. Conversely, foreigners invest to a very limited degree in Brazilian equities and fixed income securities, and the government wants to maintain the IOF tax on foreign investments in derivatives and fixed income securities at its current level.

The weaker currency must be regarded as good news for most exporters and specifically local manufacturers. Some sectors have for an extended period struggled to stay competitive, and the smaller local manufacturers have been threatened by cheap import products from primarily China. BCB's aforementioned signals to intervene in the foreign exchange market also show a certain satisfaction with BRL's current level.

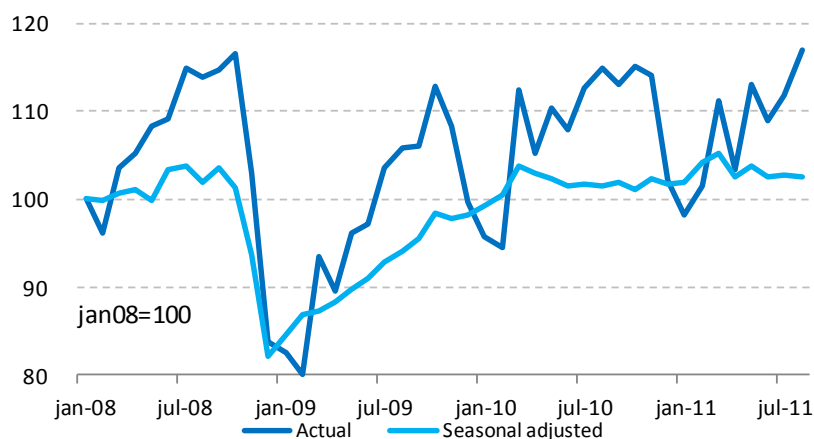
A new and slightly weaker level of BRL will also in the future continue to be supported by the Latin American giant's positive economic future and the enormous natural resources it possess. Looking further ahead Exact Invest A/S expects a continued strong and stable Brazilian Real.

Industrial production and unemployment rate

The industrial sector has probably been the sector having the hardest time following the pace of the rest of the economy. Only a slight improvement of the seasonally adjusted industrial production index can be seen during the past 18 months.

Fig. 4: Industrial production index, Jan.08-Aug.11

The industrial production has only slightly improved during the past 18 months



Source: BCB

Thus, the industrial sector shows how the aforementioned economic slowdown hinders the industrial production reaching new heights after a fast recovery following the financial crisis (fig. 4). The fact that the industrial production has not changed significantly during the past 18 months is

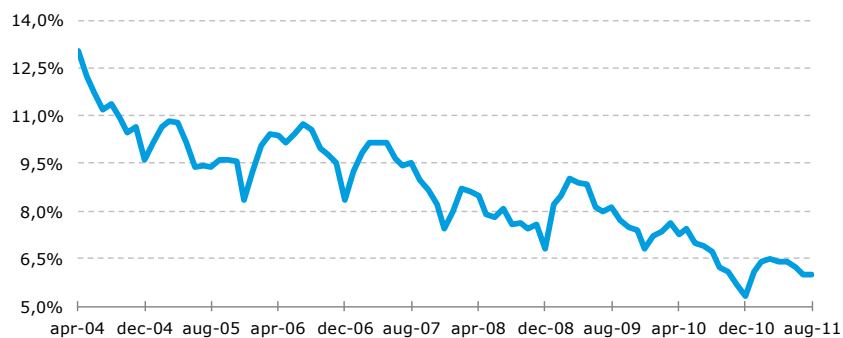
partly due to relatively high capacity utilization in the same period. Capacity utilization is currently around 84 %. The high interest rate can also be detrimental to the investment appetite. In that perspective it is positive to note that BCB made a downward interest rate adjustment at its last meeting.



Meanwhile the unemployment rate is at historically low levels. In 2011, the formal unemployment rate has averaged 6.3 % and is in August just 6 %. The low unemployment rate is a clear indicator of the positive economic transition Brazil has gone through, while shortages at the labor market can potentially push up wages and hurt the competitiveness of e.g. the industrial sector. The low unemployment must be evaluated in the light of the Brazilian population prognosis. That is, 50 million young Brazilians are expected to become available for the labor market in the run of the next 20 years. For more about the predictions of the Brazilian demography read the article [Going to Work - The Brazilian Demography](#).

Fig. 5: Formal unemployment, percentage, Apr. 04 – Aug. 11

Unemployment in August is 6 %



Source: IBGE

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 work.

Retail sales

Domestic demand is Brazil's greatest source of growth and the retail sector is one of the driving forces. Private consumption continues to grow at

a fast pace despite the slowdown currently seen in other parts of the economy.

Consumer confidence reached in 2010 a historical high and is currently continuing to be observed at high levels. More and more money is being made available to the big spending Brazilians that happily borrow extra money for consumption at soaring interest rates. An important reason for the Brazilians buying behavior is the historically low unemployment.

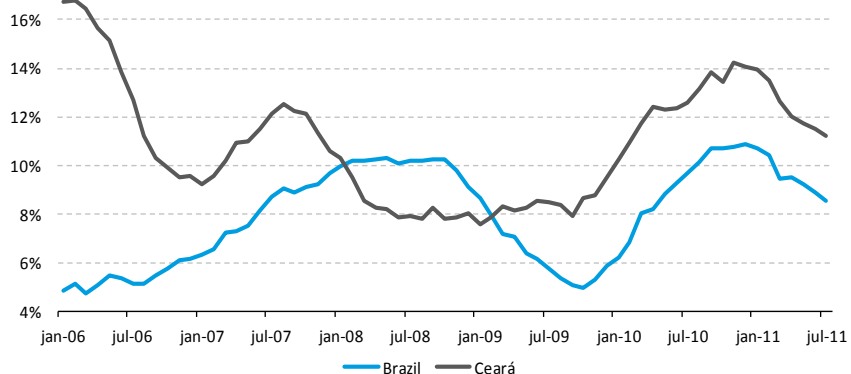
In the wake of BCB's aforementioned downward adjustment of the expected 2011 GDP growth president Dilma Rousseff said:

"The fact that Brazilians are consuming, have income, have work - that will protect Brazil" Source: AP



Between June and July the seasonal corrected sales volume grew by 1.4 %, which is the largest monthly increase in 11 months. In July the 12-months accumulated retail sales increased by 8.5 % y/y, as is shown in fig. 6. The 12-months accumulated sales are increasing at a decreasing pace, but it is worth noting that it for a prolonged period has been at a level over 10 % y/y. The largest sales increases are being registered in categories primarily containing material consumption goods.

Fig. 6: 12-months accumulated retail sales, %-increase, Jan 06 –Jul 11



Retail sales experiences robust growth in both Brazil and Ceará

Source: BCB og IBGE

In the state of Ceará retail sales grow at a level above the Brazilian total. Between June and July the seasonal corrected retail sales grew by 1.8 % m/m. The 12-month accumulated sales continue to show large increases above 10 % y/y, in July by 11.2% y/y. As is seen in fig. 6 the sales volume is

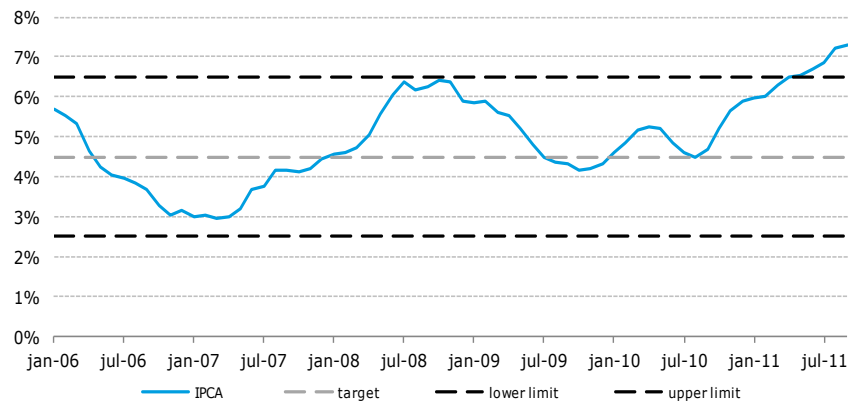
growing, as in the rest of Brazil, at a slightly decreasing pace. Compared with the whole Brazil it is interesting to note that the largest sales increases is being registered in categories primarily containing more basic consumption goods. It may be assumed to be primarily attributable to Ceará growing from a relatively lower welfare level, but it may also indicate that the state, as it matures, possesses a future potential for greater material goods consumption.

Inflation

On the inflation side, Brazil has, more than in recent years, suffered for the past 12 months. This is due to a series of coinciding events, including several already mentioned; rising food and oil prices on a global scale (see [EA-Q1](#)), strong private consumption, shortages in the labor market and greater salary increases, an insatiable demand for capacity investments, and general imbalances in the world economy.

It is still expected that the trend of the annual inflation curve, as shown in fig. 7, will revert and converge towards target in the last months of 2011. BCB reports that it expects inflation to remain within the target of 4.5 % +/- 2 %-point in the year 2011. Should inflation, contrary to BCB expectations, exceed 6.5 % p.a. at the end of year BCB president Alexandre Tombini is required to explain the deviation in an open letter to the government, and he is also required to present a plan for early reduction. In September IPCA inflation is 7.23 % p.a.

Fig. 7: Inflation – IPCA, percentage p.a., Jan. 06 – Sep. 11.



In September inflation is 7.23 % p.a.

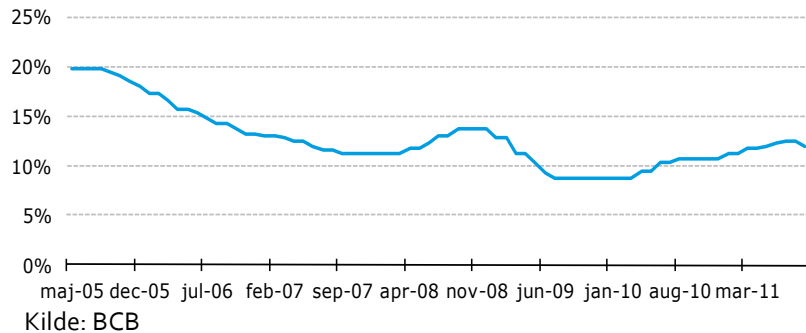
Source: IBGE

Prices rose in September by 0.53 % from August, which is close to the 2011 average monthly inflation of 0.5 % m/m. The heavy weighing price categories 'Transportation' and 'Food and beverages' continues to account for the largest contribution to the IPCA index increase. Together, the two categories contribute with more than half of the monthly index increase. After a decrease in August, the subcategory 'Airfares' recorded the largest price increase in September by 23.4% and contributes 0.09 %-point increase to the September increase. For details on the nine price categories in the IPCA index, see [ØA-Q1](#).

Interest rate

In the light of the past 12 months' rising inflation and BCB's stated intentions the decision to lower the interest rate at the last BCB meeting in late August was kind of surprising. The leading Selic-rate was lowered by 0.5 %-point to 12 % p.a. BCB had before the meeting raised the interest rate at five consecutive meetings to 12.5 % p.a. in order to dampen the rising inflation.

Fig. 8: Selic interest rate, percentage p.a., May. 05 – Oct. 11.



The interest rate was surprisingly lowered to 12 % p.a. at the latest BCB board meeting

BCB explains that the sudden rate cut is a response to a "substantial deterioration" of the world economy, and BCB president Tombini says that BCB's monetary policy also in the future will reflect the international situation. (Source: Bloomberg.com). Therefore, a further rate cut may be realized at the next interest rate meeting October 18-19.

President of BCB Alexandre Tombini



The interest rate cut is seen as a bold move since the primary objective of BCB is to keep inflation within target, which is why BCB has also received some criticism. However, it is worth noting that especially Brazil's ability to act in times of economic crisis has been highlighted in the statements released following recent years' credit rating upgrades (Fitch and Moody's). Thereby the recent interest rate cut also has a time element to it. A change in interest rate is estimated to have a lagged reaction on prices of 6-18 months.

The Brazilian interest rate cut happens alongside many other countries' monetary easing, which is also why Brazil continues to have one of the world's highest real interest rates (4.4 % p.a.).

Fig. 8 shows that an annual interest rate of 12 % is still a relatively low level historically. The recent interest rate cut supports Exact Invest A/S' medium term expectations of a downward interest rate trend alongside the process of the economy's maturation.

Dilma Rousseff in Europe

President Dilma Rousseff toured around Europe in week 40. After a meeting with EU's representatives in Brussels she told reporters:

"Brazil is ready to take on responsibility in a cooperative spirit... you can rely on us. The international financial crisis has shown clearly we must forge a joint future." Kilde: wsj.com

From left: Dilma Rousseff shakes hand with president of the European council Herman van Rompuy and president of the European commission Jose Barroso.



During her visit in Europe Dilma Rousseff promoted Brazil as an export and investment destination and presented plans for tax breaks for to investors interested in developing the country's infrastructure. Brazil seeks to attract near 70 billion BRL to invest in the telecommunication industry and it will, by new contracts, look to increase the availability of European airlines. Source: FT.com

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