

# Brazil Goes Investment-Grade

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Just five years ago, it would have been impossible to envision Brazil as an investment-grade country: The South American nation was strapped with billions in debt, and many investors believed the new, leftist President would ramp up already-high government spending. But President Luiz Inacio Lula da Silva -- a former firebrand labor unionist elected in 2002 and reelected for a second four-year term in 2006 -- has proved to be a careful steward of Latin America's largest economy. And the country has been blessed with strong international commodities prices that have transformed the onetime foreign debt defaulter into fast-growing economy flush with foreign reserves.

That explains why, on Apr. 30, Standard & Poor's upgraded Brazil's long-term foreign currency sovereign debt to investment-grade. The long-awaited move will make it possible for a wider universe of international investors, including massive U.S. pension funds, to plunge into the Brazilian stock market. The upgrade sparked a 6.3% rise in the index of the So Paulo stock exchange, or BOVESPA, which soared to an all-time high of 67,868 points. [The exchange was closed today for the May 1 holiday.]

### Positive Ripple Effects

The market is up 13.8% so far this year in dollar terms. S&P sovereign analyst Lisa Schineller said the upgrade reflects "the maturation of Brazil's institutions and policy framework, as evidenced by the easing of fiscal and external debt burdens and improved trend growth prospects." It also recognizes the government's "track record of pragmatic fiscal and debt management policies," she said.

Mike Cornelius, head of emerging market bond strategy for T.Rowe Price (TROW), says the upgrade is an "affirmation of the strong fundamental improvements we've seen in Brazil" in recent years. "It reinforces the market's perception that Brazil has done and is doing the right things, and so now it's a safer place for pension funds and other investors to invest their assets -- it's a seal of approval," he says.

The real bonus for Brazil, he says, will come when a second ratings agency -- either Moody's Investors Service (MCO) or Fitch Ratings -- also upgrades the country, something Cornelius expects this year. That's because large U.S. fixed-income investors, including pension funds and other institutional investors, use the Lehman Aggregate Bond Index as their benchmark, and it requires two investment-grade ratings for a bond to be included in the index.

The upgrade is expected to spark positive ripple effects throughout the economy. It was immediately followed by another S&P ratings boost to investment-grade for nine Brazilian banks, which have benefited from a consumer spending boom that has produced a surge in housing construction and automobile sales. Even though 33% of Brazilians live in poverty, and the country's per capita GDP is just \$5,600 -- compared with around \$7,980 in Mexico and \$8,870 in Chile -- domestic spending has been robust thanks to a steady drop in inflation, which fell from the triple digits in the 1990s to just 4.5% in 2007.

Brazilians are spending not only on durable goods but also on wireless telephone service, airline travel, and education. "One of the positive things we've seen with the improvement in Brazil's economy is that people on the lower end of the income scale are doing a lot better," says Schineller of S&P. "Brazil still has a lot of poverty, but if that could be remedied, it would mean an even stronger consumer environment."

### Doing Well Against the Dollar

Brazil is also benefiting from high world commodities prices, which since 2003 have tripled foreign reserves on deposit at the Central Bank, to a record \$195 billion at the end of April -- an amount that is roughly equivalent to the country's total outstanding public and private foreign debt. That's a far cry from the 1980s, when Brazil -- which then imported all of its oil -- was crippled by high oil prices and defaulted on its international debt. Today, thanks to large offshore oil finds, Brazil is oil self-sufficient and its state oil company, Petrobras (PBR), also boasts an investment-grade rating.

Also, today most of Brazil's government debt is denominated in local currency. That reduces the country's vulnerability to exchange-rate fluctuations, such as the ones that rocked Brazil's economy in 1998. The Brazilian currency, the *real*, floats freely and has appreciated some 7% against the U.S. dollar this year. A U.S. dollar currently fetches 1.695 reais, down from 1.81 reais in mid-January.

The International Monetary Fund estimates that Brazil is on track to grow 4.8% this year, following on 5.4% growth in 2007, when the country racked up a \$40 billion trade surplus. It is the world's largest producer of iron ore, coffee, and sugar, and is a major exporter of soybeans, pork, beef, and other foodstuffs. Companhia Vale do Rio Doce (RIO), known as Vale, the world's largest iron-ore miner, is in the midst of a multibillion-dollar expansion [BusinessWeek.com, 3/11/08].

### Spending is Up, Even Among the Poor

Brazil is more than an exporter of raw commodities, it is a leading, low-cost producer of value-added products such as hot-rolled steel and processed orange juice concentrate, as well as more sophisticated products. Its Empresa Brasileira de Aeronautica (ERJ), or Embraer, is a leading producer of commuter aircraft used by major U.S. and European airlines. Cosan, the world's biggest sugarcane processor and a major ethanol producer, has seen its share price rise 54%, while shares of USIMINAS, a leading Brazilian steelmaker and exporter, have risen 60%. And Brazil's export markets are diversified worldwide, shielding the country from the U.S. economic slowdown.

Several years of strong economic growth and low inflation have boosted consumer spending, including among the working poor who constitute the majority of Brazil's 190 million people. Expanding opportunities in retailing, wireless telephony, housing construction, auto sales, and physical infrastructure last year attracted \$34.6 billion in foreign direct investment, an amount expected to be matched in 2008. To keep that consumer boom on track without sparking inflation, which rose to an annual rate of 4.7% in March, the Central Bank in mid-April tightened monetary policy, a prudent measure applauded by S&P in its upgrade announcement. The bank increased interest rates by 50 basis points, to 11.75%.

### A Boost to Investor Confidence

Still, Brazil has been the slowest-growing of the so-called BRIC countries, a term coined in 2003 by Goldman Sachs (GS) to include the most promising hot-growth emerging markets: Brazil, Russia, India, and China. Brazil could be chalking up more robust growth if politicians could manage to approve structural reforms that would trim the country's high tax burden, whittle bureaucratic red tape, improve crumbling infrastructure and logistics, and reduce the inequality of income distribution.

Still, with Brazil's BOVESPA outperforming the world's top equity markets, the nod from Standard & Poor's should give a boost to investor confidence and perhaps give a nudge to necessary economic reforms. "We believe the investment-grade status will attract more capital inflows going forward, which have already been on the rise on the back of a responsible policy framework that has been delivering faster output growth and well-controlled inflation," UBS Securities analyst Claudio Ferraz said in a note to clients.

And it should help bring down further the risk premium that the Brazilian government must pay investors: Just before President da Silva was elected in October, 2002, when investors were jittery about a possible default, Brazilian government bonds carried a spread of 2,400 points over U.S. Treasuries. That had dropped to 300 by mid-March and fell to just 217 basis points after the S&P upgrade.

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