

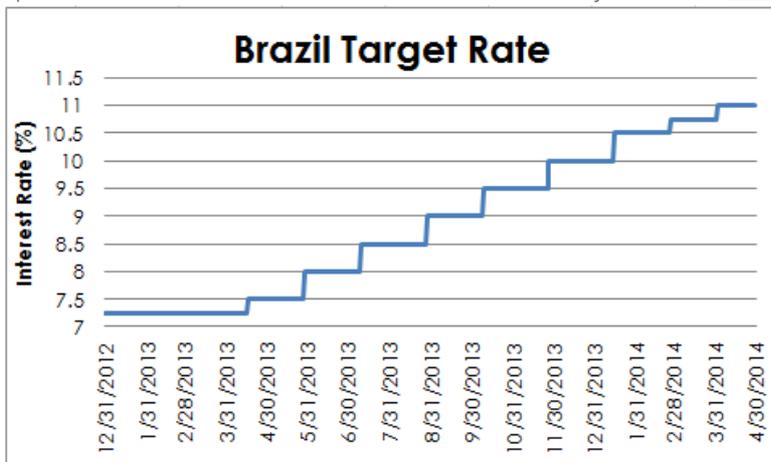
EMERGING MARKET CURRENCIES: WHAT'S DRIVING THE BRAZILIAN REAL'S STRONG OUTPERFORMANCE?

Rick Harper — CIO, Fixed Income
05/28/2014

Four months into 2014, the Brazilian real is the strongest-performing currency across the broader emerging markets (EM).¹ With most other major currencies mixed against the U.S. dollar year-to-date, what is driving the nearly 7% return for the real? In our view, a variety of forward-looking factors may have investors bullish on the real, including: • Attractive absolute and real [interest rates](#) • Brazilian Central Bank² (BCB) rate hikes to combat [inflation](#) • Declining presidential poll numbers that suggest a potential greater willingness to compromise • Increasing credibility about rumors of a Cabinet shuffle to help the economy With the World Cup just around the corner and presidential elections occurring in October, we believe globally minded investors will continue to take interest in the Brazilian economy and real.

Attractive Interest Rates Brazilian local debt and [currency forward contracts](#) offer the highest interest rates among [investment grade](#) bonds across emerging markets: five-year local debt yields 12.2%, whereas three-month forwards provide [implied yield](#) of 10.83%.³ Additionally, despite the inflation rate remaining above the BCB's target, Brazilian debt offers [real yields](#) of 4.7% to 5.0%, which are also the highest among investment-grade rated sovereigns. In the current environment, these yields provide a significant cushion against a possible deterioration in the real, which has historically exhibited a fair degree of [volatility](#). For investors still searching for yield, small allocations to the Brazilian real can provide significant yield enhancement.

Central Bank Rate Hikes and Policy Tools Even though markets tended to focus on the [Federal Reserve's](#) announcement about the scaling back of its [quantitative easing](#) program, the BCB was actually one of the most active central banks in terms of hiking interest rates to both defend Brazil's currency and confront rising inflation pressures. During the last couple of years, the central bank has sought to strike a balance between trying to support Brazil's slowing economy and keeping inflation under control. Even though Brazil saw a dip in inflation in January, it has generally run above the central bank's targets over much of the last year.⁴ In response, the BCB is expected to hike rates by 25 [basis points](#) on May 28.⁵



Source: Bloomberg, as of 4/30/14. Past performance is not indicative of future results.

As an additional policy tool, should the currency retrace from current levels and stoke inflationary fears, the central bank could help dampen price pressures by

reinstating a fresh round of currency [swaps](#) similar to ones that the central bank let expire at the end of April. In these transactions, the central bank effectively would sell U.S. dollars for Brazilian reais, giving support to the local currency. By allowing the currency to appreciate, imports become comparatively less expensive, resulting in lower prices. Additionally, exports become less attractive to foreign buyers, potentially curbing demand. Ultimately, should the BCB reinstate its currency swap program, we believe a new wave of real buyers would come into the market, pushing the currency higher.

Declining Support and Rumors of a Cabinet Shuffle Unfortunately for policy makers, Brazil's currency strength is not occurring in a vacuum. With inflation at elevated levels and economic growth stagnating at less than 2%, many Brazilians have voiced their dissatisfaction with Brazilian president Dilma Rousseff and her leadership. In our view, aggressive central bank policy has not been complemented by needed reforms on the fiscal side. Over the last several months, President Rousseff's approval rating has continued to fall in public opinion as well as presidential polls. On April 29, the Brazilian real appreciated by more than 1% on the news that Rousseff's popularity had fallen compared to her competition. In the local poll conducted by MDA, if the election were held then, 37% of Brazilians surveyed said they would vote for her, compared to 43.7% in February. By comparison, her strongest competitor, Aécio Neves, perceived as the most pro-business candidate, gained ground to 21.6% from 17%. In a similar poll, her administration's approval rating fell to 32.9% in April from 36.4% only two months earlier. While the campaign season hasn't even jumped into high gear, the trends in these polls are clearly inspiring investors to increase bets on a shift in policy. While technically still leading in the polls, President Rousseff may be on the verge of taking steps to ingratiate herself to business interests to help reverse her fall from grace.

Rousseff's Potential Response Market participants have been bullishly greeting her slide in the polls as they try to place bets in front of any potential efforts to consolidate support and appease market interests. Rumors have been circulating for months about an impending Cabinet shake-up. In the most likely scenario, current central bank governor Alexandre Tombini is expected to take over Guido Mantega's position of finance minister. Markets appear excited about this prospect. It's hoped that Tombini's recent comments about the importance of refocusing the government on its fiscal deficit would signal the administration's willingness to restrain government largesse. In Tombini's place, Luiz Awazu Pereira da Silva, a well-respected deputy governor and international affairs director of Brazil's central bank, is expected to take over the top spot at the BCB. With time running out before the election and tempers potentially rising along with temperatures this summer, markets are trying to get in front of this potentially positive catalyst. While Rousseff hopes that a change in economic leadership will help put the Brazilian economy back on track, many foreign investors are hoping that her competitors will gain additional ground leading up to October.

Outlook At present, many currency forecasters are predicting that the real will stay range bound leading up to the World Cup on June 12. However, should the real break through the 2.20 level on the back of strengthening demand, this could signal a shift in investor psychology, resulting in a possible move to the lows we saw last October (2.15, +3.8% appreciation).⁶ While interest rates are only one factor in currency trading, it is worth mentioning that rates will be a full 1.75% higher than when the currency was trading at these levels in mid-October. As we mentioned in a blog post back then, we see many potential catalysts for the [real to move higher](#), should flows into the broader emerging markets pick up steam. While volatility in the real could increase at any time, we think it offers attractive risk-reward and total return potential near current levels.¹Source: Bloomberg, as of 4/30/14 ²Banco Central do Brasil in Portuguese ³Source: Bloomberg, as of 4/30/14 ⁴Source: Reuters, as of 2/7/14 ⁵Source: J.P. Morgan, as of 4/30/14 ⁶Source: Bloomberg, as of 4/30/14

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments focused in Brazil are increasing the impact of events and developments associated with the region, which can adversely affect performance.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Inflation : Characterized by rising price levels.

Forward currency contracts : A forward contract in the forex market that locks in the price at which an entity can buy or sell a currency on a future date.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

Implied yield : The annualized rate of return generated by a fund's investment in forward currency contracts. The calculation is intended to show the yield of forward currency contracts, assuming that foreign exchange rates remain constant.

Real yield : the annual interest rate that an investor demands for holding a bond to maturity including the impact of inflation.

Volatility : A measure of the dispersion of actual returns around a particular average level. nbsp;.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Basis point : 1/100th of 1 percent.

Swap : A swap is an agreement between two parties to exchange payments based on a reference asset, which may be a currency or interest rate but also may be a single asset, a pool of assets or an index of assets.