

TIME FOR A BULLISH BET ON THE BRAZILIAN REAL?

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In a [recent blog post](#), we noted the marked rise in the trading volumes of foreign exchange markets around the world. While the purpose of this piece was to highlight the rise in prominence of economies outside the United States and Europe, we did not fully address how investors could benefit from exposure to foreign currencies. In this piece, we focus on the reasons why we believe the Brazilian real may appreciate against the U.S. dollar in the coming months. After a period of significant underperformance across all emerging market assets (equities, bonds, currencies), we believe the recent nomination of Janet Yellen as the next Federal Reserve Chair may result in a “lower for longer” path for U.S. interest rates. As a result, we believe this may have the effect of increasing asset flows into the emerging markets (EM). While investors have traditionally invested in either stocks or bonds to express a bullish view on an emerging economy, the one asset class that is expected to benefit from these flows regardless of the asset mix are those countries’ currencies. In this blog, we seek to highlight the positive catalysts we believe can lead to an appreciation in the Brazilian real through the end of 2013. **Where We’ve Been** In 2012, the Brazilian real was the worst-performing currency in the emerging markets when it declined 9% against the U.S. dollar. So far in 2013, the Brazilian real is one of the worst-performing currencies in Latin America.¹ Why? In our view, due to a combination of tepid economic growth, persistently high inflation, fiscal largesse, and corruption, expectations for Brazil among international investors diminished and the credibility of the government came under scrutiny. As a result, international investors sold their positions, repatriated their cash and looked for better opportunities domestically. Through the end of September 2013, investors have sold a combined \$6.97 billion in assets (\$4.73 billion in equities, \$2.24 billion in debt) this year.² Due to these negative investment flows and a decline in trade (commensurate with a decline in [GDP](#)), demand for the Brazilian real declined, resulting in a depreciation of the currency. In response to these outflows, the Brazilian Central Bank (BCB) announced in August that it would commit \$60 billion to support the value of the currency through December.³ **Shifting Tide** Emerging markets have been out of favor for much of 2013, but the Fed’s recent policy surprise has many investors contemplating if a rebound in EM is possible by the end of 2013. With this potential change in investor sentiment, we believe that Brazil could be a key beneficiary of this pause. Among the largest economies in the world, Brazil is one of the most widely held and watched of the emerging markets. On a [market capitalization-weighted](#) basis, Brazil accounts for over 10% of the most widely followed emerging market equity and bond indexes.⁴ For this reason, Brazil is too big to ignore for emerging market-focused investors. In our view, as flows begin to reverse, demand for the currency will increase, leading to an appreciation against the U.S. dollar. **High Carry to Volatility** Although performance in recent years has been difficult, a proactive Brazilian Central Bank (in its efforts to quell inflation) has raised rates aggressively (currently at 9.5%) in an effort to re-establish their inflation fighting credibility among investors. This has created some of the highest carry opportunities in the world. In essence, investors in currency funds who achieve their positioning through [forward currency contracts](#) are being paid to wait for currency appreciation. This high carry/income component also has the effect of mitigating volatility in the currency markets. Given that there are now up to three potential drivers of return (currency, carry and collateral income), investors have a higher margin of safety when investing. **What Will Be the Catalyst to Turn Flows Around?** In our view, the pieces may already be falling into place. The negative sentiment that drove emerging market underperformance to the lowest levels since 2009 has begun to recede. To enhance flows to Brazilian assets, a broad turnaround in EM sentiment is key. Brazil-specific issues, such as a [reduction of taxes for foreign investors](#) and continued sales of dollars by the BCB to support the currency, create an encouraging investment environment. With interest rates likely peaking near current levels as inflation begins to converge toward central bank tolerance levels, we believe growth may pick up with greater interest rate certainty. Although growth still remains well below the 2010 peak of 7.53%, we believe that with inflation expectations beginning to plateau, longer-term-focused investors may begin to increase their allocations. ¹Source: Bloomberg, September 30, 2013. ²Sources: EPFR Global,

Barclays, October 7, 2013. ³The BCB plans to spend \$500 million a day Mondays through Thursdays and \$1 billion on Fridays through currency swaps. ⁴Sources: MSCI, J.P. Morgan, September 30, 2013.

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DEFINITIONS

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

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

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.