Brazil Update

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BullTick Capital Markets

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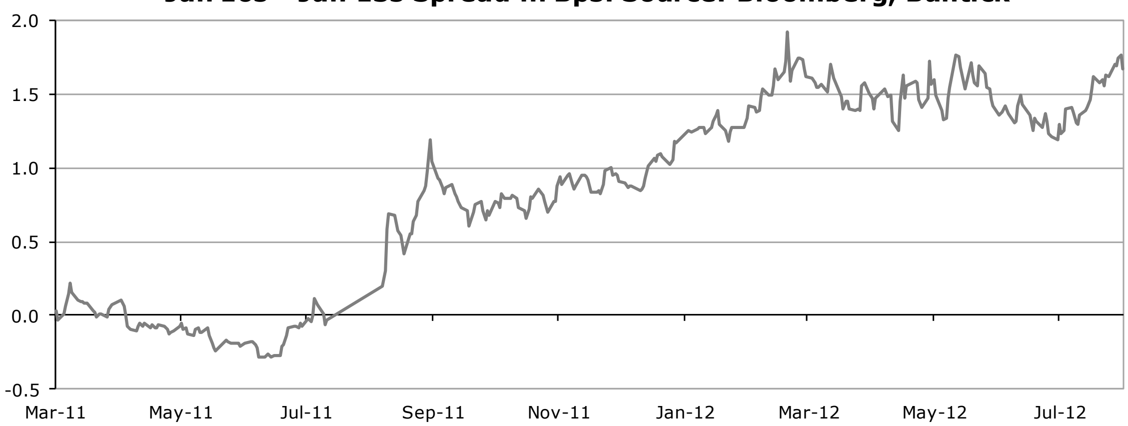
BRAZIL— COPOM Tone Turns Hawkish in Final 50bp Selic Rate Cut

Key Point: Yesterday, as expected, COPOM cut the Selic rate another 50 basis points to 7.50% in a unanimous decision, on par with our forecast both in terms of pace of cuts and quantity. The most interesting part was the accompanying statement, which was blatantly more hawkish. This, in our view, points to the realization of our long-held forecast of no further rate cuts after August and for the Selic to finish the year at 7.50%. Consensus has now moved in line with our year-end Selic forecast of 7.50%. In the past month, actual inflation readings, inflation expectations, and economic activity have picked up consistent with our call of an acceleration on both fronts in the latter half of 2012. On the inflation front, after very moderate rates of price expansion in the first half of the year, the months of July and August have shown a pick-up, surprising market expectations, and taking inflation expectations higher for the past eight consecutive weeks. The DI curve steepener trade, which we first recommended in November of 2011, has performed well. We went against consensus at that time (which some 8.5%) for year-end 2012. We expect the Selic to have to go head back towards 10.0% in 2013, which DI curve is not currently pricing in. The government is defending the BRL at the 2.0/USD level and we expect the currency to trade within the 1.9–2.0/USD band through year-end. We revised our Bovespa forecast for 2012 to 62,000 from 58,000, which would be a full-year return of 5.6% in USD terms.

COPOM Cut Selic Another 50Bps to 7.50% On Par with Our Long-Held Call for Year-End 2012

Yesterday, as expected, COPOM cut the Selic rate another 50 basis points to 7.50% in a unanimous decision, on par with our forecast both in terms of pace of cuts and quantity. The most interesting part was the accompanying statement, which was blatantly more hawkish. This, in our view, points to the realization of our consistent forecast of no more rate cuts after August for the Selic to finish eh year at 2012. Consensus has now moved in-line with our year-end Selic forecast. The DI curve steepener trade, which we first recommended in November of 2011 has performed well. We first recommended this trade in a piece in November 2011 "Inflation Peaks as Growth Slows. More Rate Cuts to Come." At that time, Jan 13s were yielding 10.12% and Jan 16s 10.78%. At the end of this month, Jan 13s yielded 7.31% and Jan 16s yielding 9.1%. The spread pickup on this trade from initiation is 111bps.

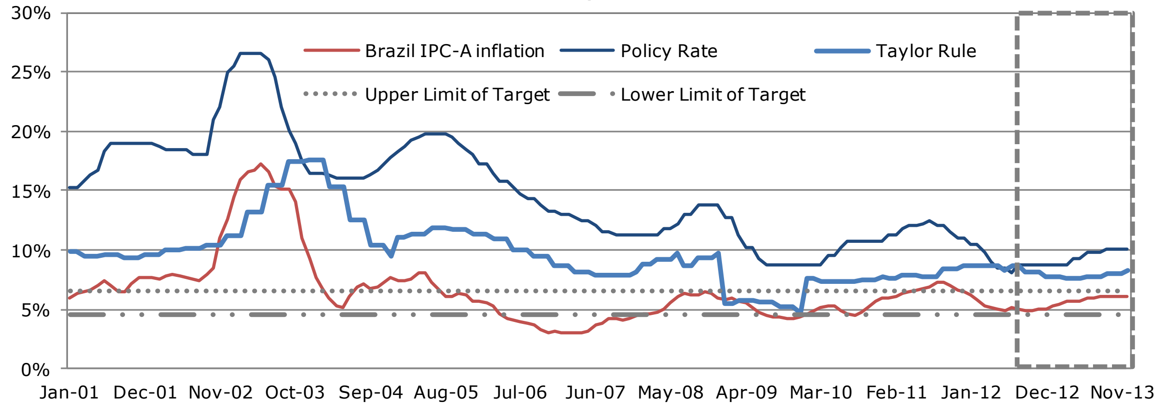
Jan 16s - Jan 13s Spread in Bps. Source: Bloomberg, Bulltick



Copom's accompanying statement to yesterday's rate decision completely removed the first phrase, "The Copom considers that, at this moment, the risks for the inflation path remain limited. The Committee also notes that, up to now, given the fragility of the global economy, the contribution of the external sector has been disinflationary." And replaced it with "Considering the cumulative and delayed effect of policy action implemented until now, which are partially reflected in the ongoing economic recovery, the Copom considers that if the prospective scenario were to allow for an additional adjustment in the monetary conditions, this move should be carried out with maximum parsimony."

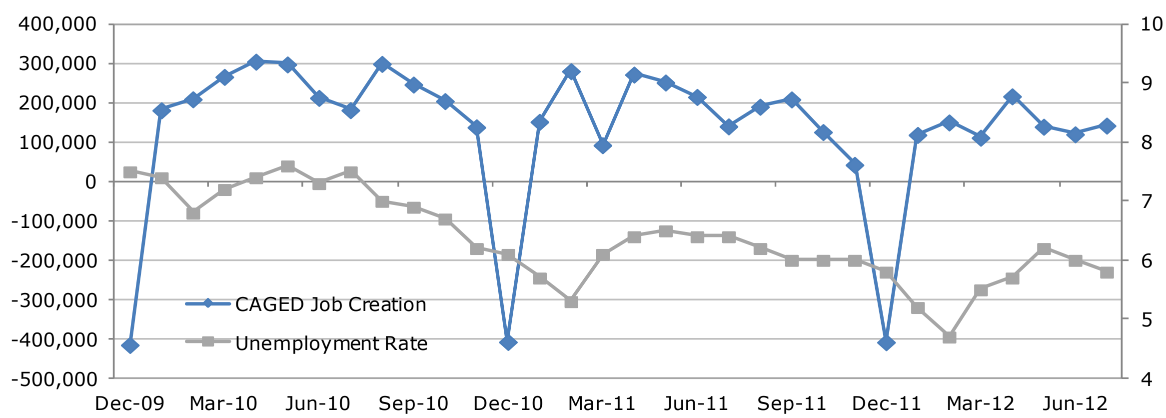
The good news, in our view, is that the central bank is not, in its pursuit of stronger economic growth, putting blinders on to indications that inflation is already beginning its resurgence. This is a positive sign when the market was at one time earlier this year faced with the question of what policy response would be when faced with higher inflation rates - staying with "inflation-targeting" regime or move to something less orthodox once both base effects wear off and growth returns. The fact that the government is turning more hawkish speaks to the observance of inflation pressures but also likely to what the government sees as a strong recovery. Indeed, over the past month, actual inflation readings, inflation expectations, and economic activity have all picked up, consistent with our call of an acceleration on both fronts in the latter half of 2012.

BRAZIL--Y/Y IPCA Inflation, CB Selic Rate. Rate. Source: Bulltick, CB



On the inflation front, after very moderate rates of price expansion in the first half of the year, the months of July and August have shown a pick-up, surprising market expectations, and taking inflation expectations higher for the past eight consecutive weeks currently at 5.2% year-over-year for year-end 2012. As we stated earlier in the year, inflation was a latent threat driven by record low unemployment rates, wage pressures and strong service sector inflation. Indeed, wage pressures have manifested in the form of large scale public sector union strikes as some 36 unions demanded between 22% and 50% multi-year wage increases from the government. [The government settled with most (30/36 took the deal and went back to work) of the unions at 15.8% over three years.] The labor market remains tight and unemployment rates near record lows. CAGED formal job creation data for July showed a still-strong labor market in Brazil, the primary driver of what we see as a likely resurgence in inflation over coming months. Some 142,496 formal jobs were created in July, an 18% month-over-month rise.

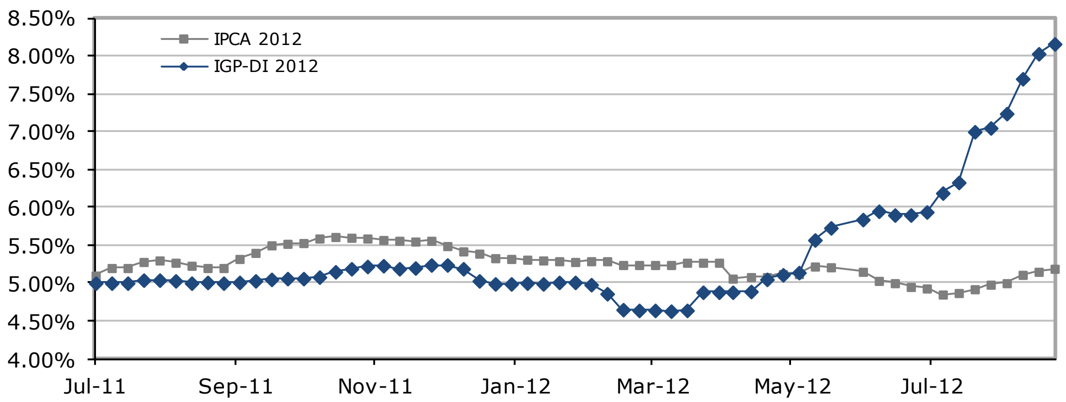
BRAZIL--NSA Unemployment Rate (Right Axis in %), Monthly Job Creation (Left Axis). Sources: CAGED, Bloomberg, Bulltick



The IPCA-15 release for the first two weeks of August accelerated +0.39% month-over-month from the prior (also upside surprise) of +0.33%. This took the measure to an annual acceleration in prices of +5.37% from +5.24% year-over-year in mid-July. We forecast IPCA inflation reading for the month of August of +0.34% month-over-month, +5.17% year-over-year. Prior to the inflection point in inflation expectations, which occurred in the week of May 11th, 2012, we had maintained that inflation was only a latent threat and that despite the slowdown in growth this year inflation would end this, next, and 2014 above the midpoint target of 4.5% due to service sector inflation, supply-demand mismatch in the economy and still-strong domestic demand as SA unemployment posts record lows. The IGP-M measure of inflation accelerated to 7.72% year-over-year, up from July's 6.7% year-over-year. Producer prices rose 2% month-over-month, construction costs and consumer prices both +0.3%. This index measures inflation with a 60% weight on wholesale prices, 30% consumer prices, and 10% construction and runs through the 20th of each month. **We expect the BCB to miss its IPCA inflation targets for the next two succeeding years. We see IPCA at 5.1% year-over-year in December of 2012 and at 6.0% year-over-year in December of 2013.**

Inflation expectations, in part a result of these wage pressures, continue the new upward (rather than the former downward) trend: According to the latest release of the central bank Focus survey, 2012 inflation expectations rose for the seventh consecutive week and growth expectations fell. Indeed, in this past week's BCB survey, consensus put IPCA at 5.19% year-over-year by year-end 2012, up from the prior week's perception of a rate of increase of 5.15% year-over-year. Expectations for the index measuring the combination of wholesale prices (60% weight), CPI (30%), and construction costs (10%), the IGP-10, sped higher, with expectations rising to +8.16% year-over-year for end-2012, up from 8.03% year-over-year the week prior and 7.05% year-over-year one month ago.

BRAZIL--FOCUS Survey IPCA & IGP-DI 2012 Expectations
Sources: BCB, Bulltick

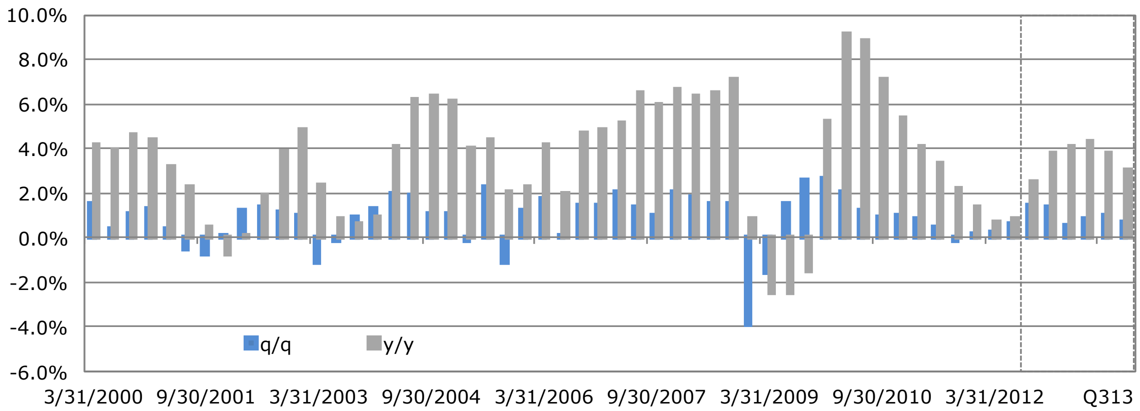


Given the quantitative inputs of the BCB's inflation target, output gap, real world rates, and actual IPCA rates, the straight Taylor Rule formula output is for an 8.00% benchmark rate by year-end 2012 and at 8.75% end-2013, different from our ultimate forecasts. This quantitative exercise serves as an input to the analysis rather than determining the forecast since Brazil-specific factors must be included in the analysis of the optimal benchmark rate. These primarily are: 1) Inflation inertia generated by still-pervasive indexation practices 2) Credit market segmentation due to BNDES subsidized lending meaning the Central Bank can only control part of the credit market 3) Government goals for economic growth and complementary monetary policy to that end.

On the economic growth front, as we wrote in our July 2012 piece, BRAZIL: Real GDP Growth Revision to 2.2% year-over-year in 2012: "While we expect a pickup in economic activity in the second half compared to first and second quarter disappointments, 2012 is set to post less economic growth than 2011's disappointing +2.7% year-over-year." In this last piece we wrote on Brazil, we revised down our real GDP growth forecast for Brazil to 2.2% from 3.2% year-over-year. We kept and continue to maintain our call for a reacceleration in 2013 to 4.5% year-over-year. Brazil's economic activity proxy the IBC-BR index, retail sales, employment gains, car sales, overall credit growth combined with year-to-date stimuli executed by the government and monetary authorities point to what we expect to be a pick-up in economic activity in 2H2012.

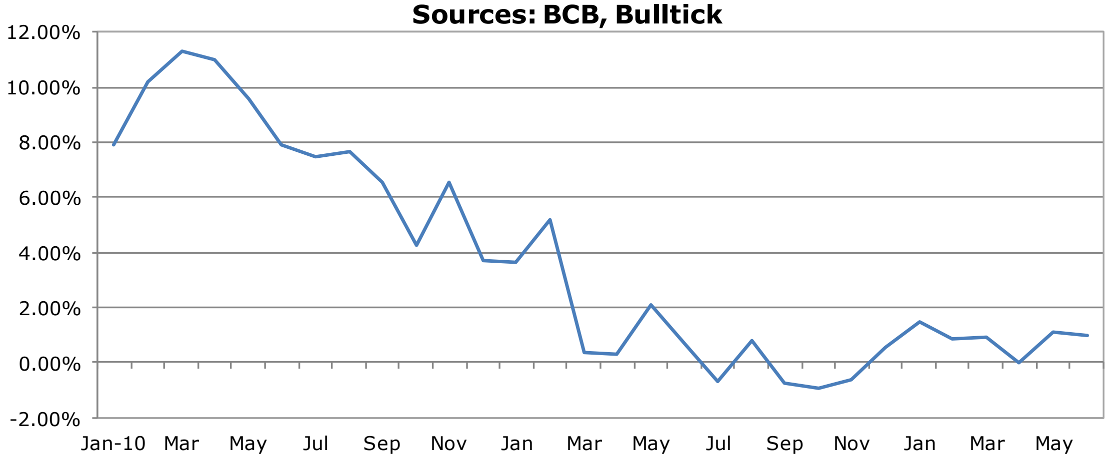
Indeed, high frequency economic indicators have shown a turnaround in June, July and August, boding for a more positive second half. Given the extremely sluggish rates of growth in the first (0.7% year-over-year) and second quarters (0.9% year-over-year is our forecast – this number is due to be released tomorrow, August 31st), we forecast 3Q and 4Q growth of 2.5% year-over-year and 3.4% year-over-year, respectively, which means growth could come closer to 2.0% for the year.

BRAZIL--Economic Growth, Y/Y, Q/Q. Forecast 2012, 2013 in Box. Sources: IBGE, BCB, Bulltick

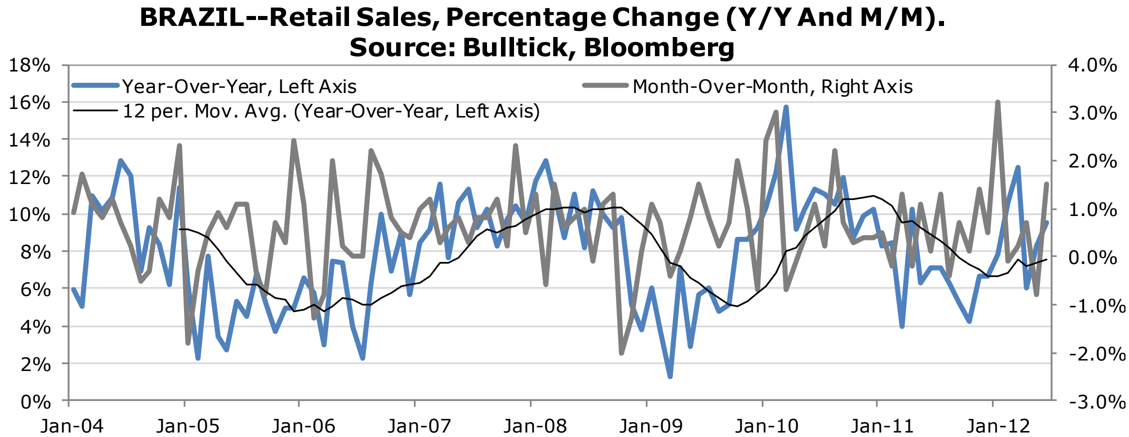


This mild re-acceleration in the second half would be based on the impact of both the government's fiscal stimulus and the delayed affects of monetary stimulus. Yesterday, August 29th, was indeed a day of stimuli as we got additional expansionary policy from both the monetary and fiscal front. The government did end up extending the IPI tax cuts on multiple areas (through October or December depending on the product), which were set to expire today, among them on cars (which has been an important reason for the added boost in sales in the past two months), appliances, and furniture as we had forecasted (see our August monthly publication). On a non-seasonally-adjusted basis, the IBC-BR economic activity index for June rose 0.99% year-over-year, SA rose 1.40% year-over-year. This is an important shift from the negative NSA annual numbers posted in April and the contractionary year-over-year SA figures of Feb and March.

BRAZIL--BCB Economic Activity Index NSA Y/Y (% change). Sources: BCB, Bulltick



The jump in retail sales of 1.5% month-over-month in June put to bed potential concerns triggered by May's monthly decline in sales of 0.8%, and seemed to enforce our long-held call for a pickup in economic activity in the second half of this year due to expansionary monetary and fiscal policy and base effects. June's number took year-over-year gains back up to +9.5% from a YTD low of 6.0% year-over-year back in April. Broader retail, which includes car sales and construction materials, jumped a hefty 12.3% year-over-year. Car sales alone jumped 16.4% month-over-month in June compared to May thanks in great part to the tax break on cars, which was originally set to expire August 31st (now extended through end-October 2012) and car-buyers rush to get that discount before the tax incentive potentially expires.



MARKET RECOMMENDATIONS

Fixed Income: *Bullish inflation linkers:* We continue to favor inflation linkers given our view of a late 2012/ 2013 surge inflation story as IP and retail sales show the supply-demand mismatch and current mix of policy absent structural reforms and infrastructure investment call for a rebound in inflation (record low unemployment rates, wage pressures, supply and demand mismatch, credit growth, etc.). This phenomenon will play out, in our view, as the benign inflation dynamics of base effects and output gap dissipate. The linker due in August 2030 NTN-B currently pays 5.2 plus inflation. An executable trade for foreign accounts in inflation linkers, would be Banco Votorantim 2016s, which pay 6.25% points +IPCA. Local currency government debt will soon have a new sponsor rooted in this year's pension reform that involves fully-funded pension plan for public servants, which itself has the authority to buy 100% government debt, a fund which will likely be a big player in this market in coming years.

Rates: *Steepener:* Following up on our trade recommendation DI curve steepeners. We first recommended this trade in a piece in November 2011 "Inflation Peaks as Growth Slows. More Rate Cuts to Come." At that time, Jan 13s were yielding 10.12% and Jan 16s 10.78%. End of this month, Jan 13s yielded 7.31% and Jan 16s yielding 9.1%. The spread pickup on this trade from initiation is 111bps.

Equities: We upgraded our forecast to 62,000 from 58,000. May's dismal price action driven by domestic risk factors as well as external risk factors and peers has calmed and the risk of a European catastrophe has subsided, calming market fears which had hit the "risk" asset classes. Much of Brazil's comparative underperformance, however, particularly compared to Mexico has to do with a more interventionist government making Brazil a more idiosyncratic story for the investor.

FX: *Neutral.* The government has been intervening keeping the BRL at 2.0/USD in the interest of helping out the industrial sector and Finance Minister Mantega has continued to rail against the currency war affecting his country, saying August 30th that Brazil will continue to work to weaken the real. We expect the BRL to remain within the band of 1.90 to 2/USD though year-end due to the government's growth-driven intervention, desire to protect domestic industry and exports, and falling Selic rate to complement that goal. The authorities have displayed their willingness to defend the BRL against aggressive appreciation or deprecation pressures, reversing dollar purchases, to sell currency swap contracts to protect the currency from what they deem them as inordinate sell-offs in times of heightened risk aversion. In May the BRL lost 9% value before the swap contracts were sold. In the month of August, the BRL has been virtually unmoved from the 2.0/USD level, gaining only 0.3%.

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