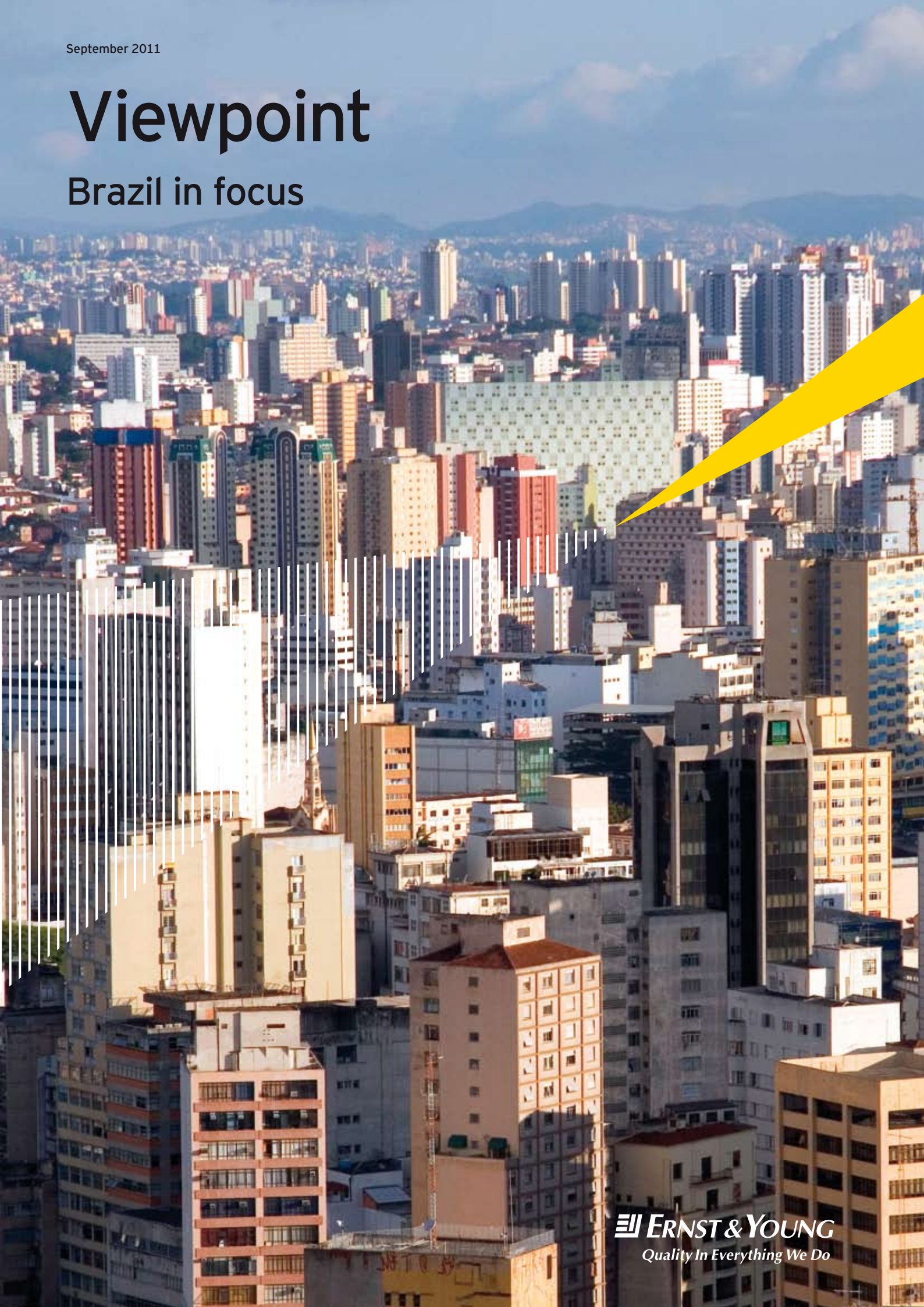
September 2011

Viewpoint

Brazil in focus



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This paper, the first in our series on the Brazilian economy, examines the current investment climate in Brazil and the opportunities and challenges that await global asset managers. Furthermore, it shines a spotlight on the economic, political and demographic factors that are fueling Brazil's economic growth, and focuses on the country's regulatory and tax regimes that could dampen this growth in the future.

Asset managers are rushing to take advantage of the country's infrastructure investment and growing middle class. But how long will Brazil's impressive economic growth continue?

For Brazil, 2010 was another good year. The economy of Latin America's largest country grew at a rate of 6.9%. Its GDP expanded to US$2.089 trillion, placing it ahead of Italy in the rankings of the world's largest economies, and just behind the UK Such impressive growth has resulted in falling unemployment and an increase in average nominal wages, which, in turn, has fueled consumer demand. Although the Brazilian Government projects that economic growth will slow slightly in 2011, it anticipates that the expansion will continue at an average rate of 4.9% yearly between 2011 and 2015.

Much of this expansion will be fueled by massive government and private investment in infrastructure. Brazil is hosting the 2014 World Cup and 2016 Olympic Summer Games, which has made infrastructure upgrades a practical necessity, not to mention a matter of national pride. It is also expected that consumer spending will continue to drive growth. The current and previous administrations have invested heavily in social programs that, supporters say, have opened the door for an estimated 20 million Brazilians to enter the middle class since 2006. These individuals now have access to consumer credit and government-subsidized credit lines, and are buying homes, cars and other consumer items for the first time in the nation's history.

With such projections in mind, asset managers, banks and hedge funds from North America, Europe and Asia are descending on Brazil, all hoping to participate in the country's long-overdue success. While many financial services providers will find ample opportunities, they will ultimately achieve success only if they navigate a maze of bureaucratic, regulatory and legal challenges that have economically hobbled this populous, resource-rich nation for decades. In this paper, we will offer a map of Brazil's unique investment terrain, identifying the forces behind Brazilian economic growth and the opportunities that investors will find over the next year. Finally, we will examine the country's notorious regulatory landscape, its high taxes and the banking infrastructure that both enables and obstructs the free flow of capital throughout the Brazilian economy.

Sound macroeconomic and social policies consistently implemented during the past 16 years have delivered an extended period of stability, growth and social gain

Upon becoming the 34th President of Brazil in 1995, Fernando Henrique Cardoso introduced long-overdue economic reforms, including the "Real Plan," a set of measures designed to stabilize the economy and tame inflation. In 2003, his successor, Luiz Inácio Lula da Silva, built on these reforms by embarking on a path of massive spending on social and infrastructure programs designed to open employment and educational opportunities for the nation's poor. The Growth Acceleration Plan (PAC), launched in 2007, provided tax incentives that were designed to spur more robust economic growth. It also allocated US$323 billion to the power grid, US$56 billion to transportation and logistics programs and US$109 billion to social and urban projects. The PAC delivered a 5.1% growth rate in 2008 and, many argue, helped Brazil recover from the 2008 economic downturn more quickly than other Latin American economies. At the same time, the Brazilian Government aggressively continued efforts to lower inflation, which delivered results. In 2002, inflation stood at 12.5%; by 2007, that number had plummeted to 4.5%, where it would hover for the next four years. Today, inflation remains within the Government's target range, although a rise in commodity prices has led some inflation expectations to climb.

The most notable result of Lula's reforms has been the marked increase in economic opportunity for Brazil's poorest citizens. Between 2001 and 2009, the income growth rate of the poorest 10% of the population was 7% annually, while that of the richest 10% was 1.7%. This helped reduce income inequality (measured by the Gini index) from 0.59 to 0.54 during the same period. The number of Brazilians earning monthly wages between US$581 and US$2,508 has grown to 52% of the population, representing more than 100 million people. In short, millions of Brazilians have left poverty and have entered the consumer class. This trend has driven a remarkable consumer spending spree, as many Brazilians purchase their first cars, homes and electronics. They are also acquiring credit cards at a brisk pace. According to the Lafferty Group, in 2010, Brazilian consumer credit card debt increased by 28.9%.

Global companies now view Brazil and its shopping classes with tremendous optimism and are pouring investment dollars into the country. In May 2011, Brazil's Central Bank revealed that foreign direct investment for the previous 12 months had reached US$64 billion, the largest annual amount since records began in 1947.

The Brazilian Government, since January 2011 headed by Dilma Rousseff, is preparing to launch a second PAC program, a US$900 billion infrastructure scheme that will fund transportation, energy and facilities upgrades required for Brazil's hosting of the 2014 World Cup and 2016 Summer Olympics. Infrastructure spending on this scale and the growing spending power of a burgeoning middle class form the two cornerstones of Brazilian economic strength and, according to the Brazilian Ministry of Finance, should sustain economic growth at or near 5% annually through 2014.

Despite the challenges of Brazil's regulatory environment, foreign asset managers are competing aggressively for a piece of an expanding market

Asset managers entering the Brazilian market for the first time will find a tangled maze of federal, state and local regulation. Traditionally, these regulations have served to keep Brazil's banking and asset management industry firmly in Brazilian hands. At its highest level, regulatory authority rests with the National Monetary Council (CMN), which plays a pivotal role in the Brazilian financial regulatory system. The CMN oversees four regulatory entities: the Central Bank of Brazil, the Securities and Exchange Commission, the Private Insurance Superintendency and the Complementary Pension Secretariat. From these four regulatory bodies spring myriad rules, regulations, laws and guidelines that can prove overlapping, antiquated and costly. Many foreign firms doing business in Brazil find that partnering with established Brazilian companies is the best way to enter the market and establish regulatory compliance.

For international asset managers working in Brazil, there are two specific restrictions that prove daunting. The first is that any foreign investment in domestic financial institutions requires a presidential decree, as well as authorizations from the relevant regulatory entities. In determining whether such an authorization will be given, the Central Bank considers the size of the ownership stake the foreign firm plans to hold, the anticipated benefit to Brazil's banking sector and national economy, and the role that the Brazilian firm will play in the foreign firm's strategic plans. The second, more draconian requirement appeared in June 2009, when the Central Bank ordered the closure of unregistered representatives of international banks operating in Brazil. Traditionally, banks had been able to operate domestic subsidiaries without registering their offices. When the Central Bank ruled that such offices were, in fact, illegal, many foreign wealth managers closed their branches in Brazil.

Despite the regulatory difficulties of operating in Brazil, many financial institutions continue to partner with established Brazilian firms to establish beachheads in this market. For example:

- **July 2008:** Prudential Financial entered into a strategic partnership with Brazil's GAP Asset Management. The initial focus of the partnership is in the areas of retirement, wealth management and the development of mutual fund products.
- **January 2009:** Royal Bank of Canada opened an investment advisory practice in São Paulo to provide investment advice to high net worth Brazilians.
- **October 2009:** Aberdeen Asset Management established an office in São Paulo to focus on research and management of Latin American equities.

Although there is a passing acknowledgement among some in President Rousseff's administration that excessive financial regulation hurts consumers and could ultimately backfire as Brazil seeks greater access to foreign markets for its own products and services, few expect the Government to implement a more laissez-faire approach to regulation anytime soon. Many credit Brazil's stringent banking laws with saving the national economy from the worst effects of the global financial crisis. Further, the current regulations do what they are intended to do: protect Brazilian banks and government control over those banks. Foreign asset managers entering the Brazilian market face strong competition from a very competent set of domestic wealth managers, many of whom have international links and enjoy major home-field advantages. Additionally, most of the largest domestic banks have onshore wealth management services.

Brazil's tax burden: among the highest in the world

Brazil's combined corporate tax rate for 2011 is 34% (40% for financial institutions). The tax consists of a basic tax of 15%, plus a surtax of 10% for annual income over approximately US$110,000. An additional 9% (15% for financial institutions) is levied for social contribution on net profits. The tax system itself is a labyrinth of local, state and federal taxes complicated by a host of assessments and "contributions." The system is so cumbersome that an average-size corporation in Brazil spends roughly 6,000 labor hours per year complying with all of its legal obligations and tax payments. In the United States, comparable firms spend roughly 200 hours annually on such matters.

Some Brazilian political leaders and economists have declared that the country's reputation for high taxes stymies foreign investment and dampens domestic productivity. Consequently, there is now some movement toward changing the tax system: on the campaign trail, Rousseff herself promised to pass tax reform within a year of taking office. To date, these campaign promises have yet to become real reform. In fact, in the past year, the Government has shown that it is not shy about raising taxes. According to The Wall Street Journal, the percentage of foreign investors participating in the domestic debt market continued a long-running decline in April 2011 to 11.29% from 11.36% the previous month. The decline was due primarily to Brazil's decision last October to raise its IOF (financial operations tax) on foreign investment in fixed income and derivatives markets. This tax increase was part of an effort to curb heavy incoming foreign investment and the consequent rise in the value of the local currency, the real. The currency has gained about 40% against the US dollar over the past two years.

The Brazilian financial system is highly regulated and concentrated, with low leverage ratios and strong domestic players

The Brazilian financial system is dominated by six domestic banks, which control an overwhelming majority of banking assets. Of these, state-owned banks account for roughly 43% of assets under management (AUM), while private banks control 39%. Foreign-owned banks account for roughly 18% of AUM. Over the past 15 years, state-owned banks have, in terms of credit, increased their presence in the financial services market, an expansion that has come at the expense of foreign players. Mergers and acquisitions will continue as larger domestic banks acquire smaller private institutions, while foreign banks try to establish a foothold in the market through partnerships and acquisitions.

In terms of wealth management and investment banking, Brazil's market grew by 15% in 2010, and is expected to remain one of the fastest-growing segments of the financial services industry for the foreseeable future. The large domestic banks all offer services tailored to the needs of Brazil's growing investor class, though three have traditionally dominated the market: Itaú Unibanco, Bradesco and Banco do Brasil. Foreign investment banks, such as Credit Suisse Hedging-Griffo, Santander and Citi are moving aggressively into this market through acquisitions and partnerships. UBS re-entered the market in 2010 after selling its Brazilian private banking operations to BTG Pactual in 2009.

The Brazilian securities markets are somewhat limited, the natural result of heavy regulation and limited product offerings. Brazilian law currently restricts the number of funds available to seven, and each of these funds is regulated differently. Many Brazilian investors have traditionally avoided domestic markets altogether in favor of foreign markets with a broader variety of opportunities. The country's stellar economic growth has changed this dynamic somewhat, with Brazil's growing investor class seeking opportunities domestically. And, while high interest rates have slowed a movement toward alternative investments, many investors are embracing exchange-traded funds, real estate funds and hedge funds. Earlier this year, hundreds of curious investors attended the first Hedge Fund Brazil Forum in Rio de Janeiro. According to Hedge Fund Research, in 2010, hedge fund assets devoted to Brazil rose 75% to US$21 billion.

Despite inflation fears and growing currency concerns, Brazil's economy will likely grow in the near term

With heavy public and private investment in infrastructure and a rapidly growing consumer class, Brazil is poised to enjoy uninterrupted economic growth in the near future. For now, public expenditures will be funded primarily through heavy taxation, but also through the sale of government treasuries, which are paying 12% to 27%.

Among the weapons Brazil deployed in its battle against social and economic inequity was the extension of low-interest, government-backed credit lines to individuals. With access to this credit, Brazilian consumers have responded by going on a housing and consumer products spree, which, along with public expenditures on infrastructure, has resulted in increased trade with China, Europe and the US. This growth, along with the promise of massive, pre-salt petroleum reserves, has transformed Brazil into a global economic powerhouse. But artificially cheap credit comes at a price. Consumer demand pushed the inflation rate up to 6.13% to March 2011. The Central Bank has raised benchmark interest rates twice this year to 11.75%, up from 10.75% in January. Central Bank economists believe that the economy is already slowing due to past rate increases, and that inflation will fall within its target range in 2012.

As the country's economy continues to grow, its currency is appreciating. The stronger real has led to a widening trade imbalance. Brazilian consumers are taking advantage of a real that buys more foreign goods, creating a current account deficit of 2.31% of GDP for 2010.

Rousseff has promised to continue Lula's popular reforms, and will no doubt leave government-backed credit lines open. Millions of her newly prosperous constituents demand nothing less. At the same time, she has committed to cut billions in government spending in an effort to cool the economy and make Brazil administratively more efficient. The two goals may, in the future, prove contradictory. But over the near term and perhaps much longer, Brazil may well continue its current economic ascendency.

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