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## Brazil well-placed for the economic storm

By Nick Rice

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At the beginning of 2008, Brazil looked to many investors like the model of decoupling. Its financial system had little crossover with US subprime or investment banking in the developed world.

Its commodity exports, particularly iron ore, looked strong in an era of rocketing prices. But 2008 also highlighted the importance of Brazilian domestic consumption. Growth remained solid due to flourishing but conservative lending and well run groups in sectors such as retailing and telecoms.

At the start of 2009, all these factors potentially still apply, but with a key exception: the decoupling model has broken. Institutions have lowered their credit growth forecasts. Countries spending on infrastructure to stimulate their economies will need iron ore, so hard commodity prices could rise in the longer term.

But the epic pricing power of the first half of 2008 is unlikely to repeat itself in the near future.

However, the economy remains much better placed to ride out the slowdown than it would have been in the past, as Andre Loes, chief economist at HSBC Brazil, explained at the World Federation of Investors Corporations' congress in São Paulo.

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"At the start of the 1990s, we had a very closed economy. We had a very weak balance of payments and hyperinflation. The state owned industries that it shouldn't have," he said. "In the late 1990s and early 2000s, we established an inflation-targeting regime. We approved a fiscal expenditure law. The state could only raise spending if it raised taxes."

When high commodity prices, high interest rates and a strong currency entered the equation, the equity markets experienced powerful year-on-year growth. According to Brazilian stock exchange BM&F Bovespa, Brazil had seven IPOs in 2004 and nine in 2005. By 2006 it witnessed 26, while in 2007 it netted 64.

But by mid-September, the markets had seen just four new companies coming to market in 2008. Nor has the yield on Brazilian stocks incentivised investors to return. With the exception of utilities, domestic companies find it difficult to compete with high rates from savings accounts or government bonds.

However, in fixed income, this has proved extremely advantageous.

Even despite their conservative lending practices, Brazil's banks are still forced by law to be among the best capitalised in the world. Financial uncertainty has also catalysed merger and acquisition speculation in Brazilian banking, which was started by the fusion of Banco Itaú and Unibanco towards the end of last year.

As Roberto Teixeira da Costa, the former chairman of Brazilian financial regulator CVM, put it when Lehman Brothers collapsed in September: "We are undergoing a crisis of confidence. When that sets in, it's extremely serious."

"Morgan Stanley's capitalisation is half that of Banco Itaú. These numbers astound us. We have no idea when confidence will come back. World trade will be affected. Investors will be affected. Your perception of risk changes at moments like this. Nevertheless, when the dust settles, Brazil will be in a good position."

*Nick Rice is chief reporter at Investment Adviser*

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