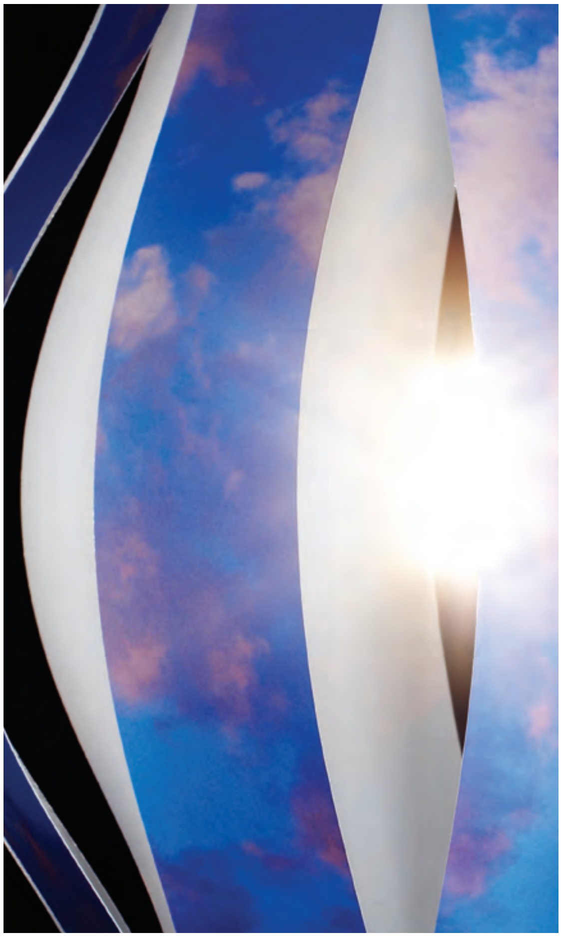


More to Bountiful Brazil Than Commodities

By

The BNY Mellon ARX Team

BNY MELLON ARX

Executive Summary

Having weathered the global economic downturn better than many countries and performed robustly in 2009, we believe Brazil offers promise for 2010 amid the expectations for strong growth led by domestic demand. In the near term, the upcoming presidential elections in October may arguably have a disproportionate impact, given Brazil's status as an emerging market, with the potential to create market volatility, according to Alexander Gorra, director at BNY Mellon ARX. The charismatic Luis Inacio Lula da Silva, widely known simply as President Lula, is preparing to exit the presidential stage having reached the limit of two consecutive terms in office. Legislative elections — at different levels including state governors and members of the bicameral national congress — also take place in October. The new administration will begin to govern in January 2011.

Since the military peacefully ceded power to civilians in 1985, it is a measure of Brazil's political maturity that the country has comfortably moved from center right to center left, a direction that may well be reversed in the coming election. Irrespective whether Dilma Rousseff, personally nominated by Lula and his chief of staff, or her main opponent Jose Serra, the current governor of Sao Paulo, wins, both are committed to fiscal discipline and economic stability, and are expected to maintain a de facto independent central bank.

Swift Exit From Recession

Thanks to the government's prudent management of the economy, the recession, although the sharpest in Brazil's history, has been relatively short, lasting only two quarters. The economy grew 2% in the final three months of 2009. The country's 2009 gross domestic product (GDP) growth rate came in at -0.2%, while our macroeconomic team forecasts 2010 growth at 7.5%.[1]

Brazil has been enjoying historically low interest rates, with the benchmark Selic interest rate at 8.75% since July 2009.[2] The reduction to 8.75% was possible thanks to strong macroeconomic and monetary policies, a marked contrast to February 2003 when the Selic rate went to a decade high of 26.5% with inflation above 9% (see Exhibit 1).

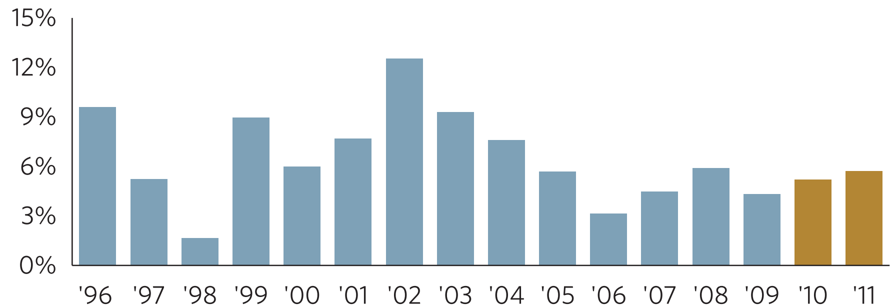
1 U.S. Department of State, *Background Note: Brazil,* September 9, 2010; BNY Mellon ARX forecast.

2 SELIC – Special System for Settlement and Custody (Sistema Especial de Liquidação e de Custódia). Brazilian SELIC Target rate (Meta do SELIC) is the benchmark rate set by the Brazilian Central Bank. The SELIC target was created on March 4, 1999, replacing the TBC and TBAN rates (the previous benchmark rates).

In July 2010 the Brazilian Central Bank raised the Selic rate to 10.75% annually. It was the bank's third rate hike since it kicked off a tightening cycle in April. Diminished inflation pressure caused year-end market forecasts to slip to around 4.8%. Brazil's government has set inflation targets of 4.5% annually for 2010 and 2011.[3] Lula has pursued orthodox economic policy, mindful that inflation has to be kept under control to have higher incomes and more consumption.

Brazil has accumulated in a relatively short period of time a significant amount of foreign reserves, amounting to US$270 billion.

Exhibit 1 – Macroeconomic Stability
IPCA – The Brazilian Consumer Price Index



Source: IBGE (Brazilian Institute of Statistics) as of June 2010.

Despite some significant targeted stimulus, Brazil is still running a primary budget surplus. Economists consider the surplus, excluding interest payments on the outstanding debt, to be a gauge of a country's ability to service its debt. As a stimulus measure, policymakers, beginning in September 2008, injected about 100 billion reais into the economy. In April the government posted its largest monthly primary budget surplus in two years, bringing the balance for the year through April to 24.7 billion reais, the equivalent of 2.3% of GDP.[4]

Brazil has accumulated a significant amount of foreign reserves, amounting to US$270 billion according to the Banco Central do Brasil. Contrast this with the end of 2004 when international reserves were approximately US$53 billion.

The country has considerably improved its debt ratios, enabling it to reduce its vulnerability to external shocks and excessive dependence on international capital flows. International investors represent around 25-30% of trading volumes but in some recent initial public offerings (IPOs) that can be closer to 70% of the IPO allocations. Foreign Direct Investment, which is very important for Brazil's development, has been running at a rate of approximately US$40 billion a year.[5]

3 Gerald Jeffris, "Brazil Inflation Surprise Shifts Central Bank Rate Stance," *The Wall Street Journal,* July 29, 2010.

4 "Brazil Central Government April Budget Surplus Surges," Reuters, May 26, 2010.

5 World Bank, World Development Indicators.

The middle classes have become the majority for the first time in Brazil's history.

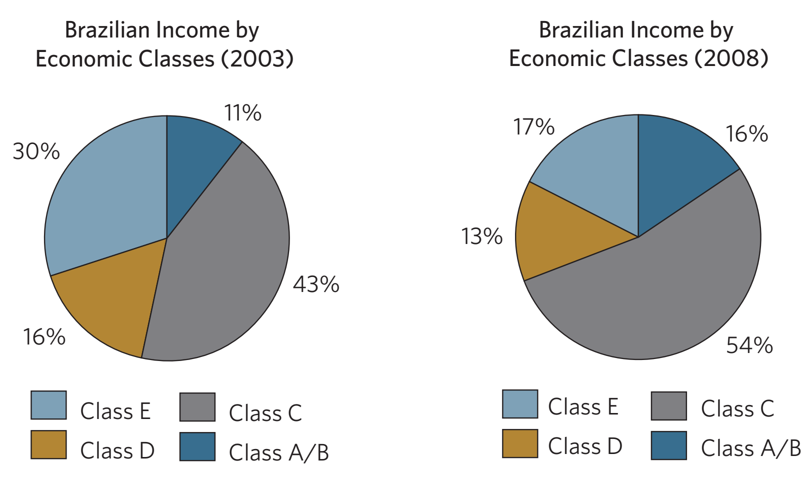
Effective October 2009, the Brazilian government increased the tax on financial transactions (IOF) related to foreign investments in the Brazilian financial and capital markets from zero to 2%. The imposition of the IOF tax is intended to discourage a speculative bubble in the Brazilian capital markets, reduce the appreciation of the Brazilian real and counteract inflationary pressures.

Youthful Dynamism and Natural Riches May Provide Competitive Advantage

Brazil, which has the fifth largest population in the world, has a pyramid-shaped demographic structure. The 0-14 years segment of the population comprises 26%, the 15-64 years portion 67% and 65 years and over 6%. Brazil's median age is 28.6 years, compared with 40.2 years in the UK or 36.7 years in the US. Young people are mainly entering the workforce, which will help to expand Brazil's revenue base over the coming decades.

A significant portion of the population has enjoyed upward social mobility, with many lifted out of poverty. Social class C (lower middle and skilled working classes) has expanded from 43% in 2003 to 54% in 2008 (see Exhibit 2 below). The middle classes have become the majority for the first time in Brazil's history.

Exhibit 2 – Income Growth



Source: Fundação Gertulio Vargas/Centro de Políticas Sociais

The positive demographic conditions and improved social mobility are among the factors that favour increased domestic demand. Moreover, compared to the developed world, Brazilian consumers are not burdened by excessive debt and have the scope to borrow more. Similarly, the country's banks are not "overleveraged" and stimulus measures, such as tax reductions and low-cost loans granted by the state development bank BNDES, have also given a fillip to domestic consumption.

In our view, Brazil has a potential GDP growth rate of approximately 5.5% in real terms.

Brazil's hosting of the World Cup and the Olympics in 2014 and 2016, respectively, is also expected to give a boost, spurring the development of Brazil's infrastructure, which needs upgrading and has been a focus of the PAC[6] economic and tax package. (The PAC, which included the creation of a fund to invest in infrastructure projects, has been strong on rhetoric but weaker on delivery.) The Olympics, together with the discovery of oil in the Santos Basin and the hosting of the 2014 World Cup, are expected to add about 3-4% of GDP in the coming years.[7]

With the prospects of slower growth in the U.S. and Europe and of China's slowing its expansion to control inflation, commodity demand is not expected to be as strong as the 'super commodity cycle' of 2000-2008. In contrast to other Latin American countries, Brazil is less dependent on commodities and accordingly less vulnerable should commodity prices fall. However, stocks that are driven by consumption still trade at a discount to commodities, offering potential for upside for the former category.

As well as a well-developed mining sector, land-rich Brazil is in our opinion strong in agriculture. Just as there is demand from China for Brazil's commodities, its agricultural products are highly sought after. By 2005, more than 60% of China's imports of orange juice came from Brazil, as well as one-third of its soya bean and tobacco purchases.[8]

In our view, Brazil has a potential GDP growth rate of approximately 5.5% in real terms. Any growth above this figure brings the risk of inflation. Over time, as Brazil invests more in infrastructure, both physical, such as roads and bridges, and in the education of its youthful population, Brazil may eventually be able to increase this growth rate. In any case, a potential 5.5% growth rate is almost double the amount Brazil has grown on average over the past two decades.

The Brazilian Markets: Tapping into Domestic Potential

Given our conviction about the growth prospects of the domestic-oriented portion of the market, we believe companies focused on the domestic market may have greater potential. In particular, we believe companies exposed to Brazilian domestic consumption as well as meat exporters and certain areas of the financial sector seem promising. Rising income levels and more expensive tastes in export countries such as China are driving demand for Brazilian beef, pork and poultry. Meat consumption is also rising locally. Brazilian financial stocks have benefited from not being highly leveraged and from their lack of exposure to the subprime problems emanating from the US.

6 Programa de Aceleração do Crescimento.

7 Dian L. Chu, "Olympics Effect: Now It's Brazil's Turn to Benefit," *Seeking Alpha*, October 5, 2009.

8 Jerry Hirsch and Henry Chu, "Brazil's Rise as Farming Giant Has a Price Tag," *Los Angeles Times*, August 22, 2005.

Overall, we believe, Brazil offers liquidity and breadth of companies and sectors.

With consumers largely "underleveraged," they could benefit from an expansion in credit. Given our expectations on Brazil-led consumption, we are not as optimistic on commodities-related stocks, though we continue to expect commodities demand from China to be high, moving into 2011.

Despite Brazil's historically lower growth rates than those of emerging Asia over the past decades, Brazil has shown notable price/equity appreciation in most cases as evidenced by historical pricing data. This is mainly due to the improvement in corporate governance and in respecting minority shareholder rights. We expect these improvements to continue as investors are more selective in their allocations. Overall, we believe, Brazil offers liquidity and breadth of companies and sectors.

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