Brazil's promotion wins admirers

EMERGING MARKETS

Two major ratings agencies have lifted Brazil's long-term sovereign debt to investment grade status. **Ruth Sullivan** looks at the implications

Institutional investors are likely to take a fresh look at Brazil following ratings upgrades by two big agencies in the past two months.

Standard & Poor's and Fitch have both upgraded Brazil's long-term sovereign debt to investment status, which means the country is now considered a safe investment destination unlikely to default on its debts.

It has only gained the lowest rung of the investment grade ladder, a long way from the triple A status of developed economies such as the US, Britain or Germany. But the change will nonetheless make it more attractive to a broader range of international investors such as big US pension funds, which are constrained from investing in countries that have not had their capacity to repay debt positively assessed, say fund managers.

Just six years ago the country was widely seen as being on the brink of bankruptcy and many investors would have found it impossible to see Brazil as an investment-grade country.

"The upgrade opens Brazil to a wider investor audience. A lot of funds will only move into a country when it has investment grade rating," says Julian Thompson, head of emerging market equities at Threadneedle.

Brazil equity funds have just seen their sixth consecutive week of inflows, totalling $1.4bn (£716m, €901m), compared with net outflows of about $632m before that period, according to Boston-based Emerging Portfolio Fund Research, which tracks global fund flows.

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"Investors have been attracted to Brazil based on better than expected recent economic growth and the government's past commitment to responsible fiscal policies that led to fiscal surpluses and mounting foreign exchange reserves," says Brad Durham, managing director of EPFR.

The strong flows into Brazil's equity funds come as emerging markets funds in general have suffered severe outflows. The MSCI Brazil index is up almost 20 per cent since the beginning of January, while the MSCI Emerging Markets index is down more than 3 per cent.

Fund managers see the investment grade more as a seal of approval than dramatically changing fundamentals. "When Mexico gained its first investment grade rating in 2000, North American investors gradually began to add Mexican equities to their portfolio," says Urban Larson, fund manager of F&C's Latin American fund. He expects a similar pattern to emerge with Brazil.

Although Brazil is the last of the Bric countries (the others being Russia, India and China) to gain investment grade status, many Latin America and Bric fund managers are overweight in the country's stocks.

"We've been fans of Brazil for a long time . . . and expect to maintain an overweight position. Any increase [in weighting] will depend on new companies coming to market," Mr Thompson says.

Investor appetite has traditionally focused on commodities in a country with significant natural resources, but domestic stocks are beginning to gain some attention as domestic spending and consumption grows. "Brazil is the place where we see the most exciting opportunities," says Stefan Herz, Latin American fund manager at Charlemagne Capital, an emerging market fund specialist.

"There have been so many initial public offerings in Brazil in the past few years and the emergence of new sectors."

The information technology, real estate and healthcare sectors have also made a debut. "It is the only Latin American country where this has happened."

Brazil makes up more than 67 per cent of the weighting of Charlemagne's Magna Latin America fund.

Nicholas Morse, Schroders Latin America fund manager, is also positive on Brazil. Schroders' $1.9bn Luxembourg-listed Latin America fund counts Brazil as the "largest overweight country in the portfolio". The company's $14.5bn Bric fund is also overweight in Brazilian equities.

On a short term outlook, Mr Morse says equity and fixed income markets have already discounted Brazil's investment upgrade. But from a longer term perspective, "the status is good for foreign direct investment, especially for sectors [such as] infrastructure".

At Threadneedle, where 22 per cent of the Global Equity Markets fund is in Brazil, compared with 18 per cent in Russia, 11 per cent in China and just 4 per cent in India, Mr Thompson also sees the attraction of investing in property. "The demand for middle income residential property is strong and remains relatively good value."

He emphasises the importance of good stock-picking. "Once an investment grade rating has happened, the country [debt] risk has been reduced so there is not so much improvement to come. Then it is more about stock-picking."

In the financial sector, the fund is looking outside banks, which are growing their loan books strongly but not their earnings, and at companies such as Redecard, a credit card transaction processor.

Another outcome of the rating change is that investor confidence will be boosted enough to encourage investors to look beyond traditional commodities and move into domestic stocks, says Mr Larson of F&C.

F&C's Latin American Equity fund has been adding Brazilian domestic companies to its portfolio with AmBev, the brewery, which Mr Larson is expecting to show strong volume growth this year. The fund has also added Unibanco to its bank holding and invested in the stocks of All, a railway company, and Localixa, an auto rental company.

But some concerns still remain in the investment community, particularly the spectre of rising inflation and the question of whether current strong commodity prices can be sustained.