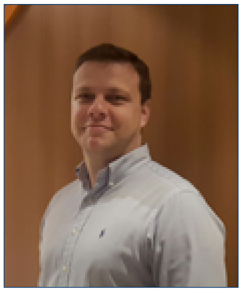
Mirae Asset Brazil Macro Strategy

Q&A with Andre Pimentel
Director of Investments



Andre Pimental
Director of Investments
Mirae Asset Global Investments (Brazil)

Corporate Story & Portfolio Manager

1. What is the history of Mirae Asset Global Investments in Brazil?

Mirae Asset entered Brazil nearly ten years ago in 2007 with an initial focus on equity funds. The mutual fund suite was progressively extended with fixed income and balanced product launches in order to meet market demand. In addition to providing capabilities across traditional asset classes, we are also fully proficient in multi- and macro strategy solutions alongside alternative investments, notably in real estate.

Most of our funds are well placed when compared to the peer group and enable the investor to obtain positive returns regardless of domestic conditions. For example, the Mirae Asset Macro Strategy Fund is about to complete three years of quality performance with reasonable volatility. This fund seeks returns above CDI (an index highly correlated with the SELIC rate) using the macro scenario to build local strategies in most asset classes available, such as fixed income, equities (long-only and long and short), and currencies.

2. Describe your current position with Mirae Asset Global Investments (Brazil).

I joined the firm in 2011 to manage the Mirae Asset IMA-B Fixed Income Fund and to cover local and international fixed income across all funds, especially the multi-market ones. The IMA-B fund has shown consistent performance, remaining within the top of the category to this day. In 2013 we launched a macro strategy fund to claim a stake within an exceptionally popular category in Brazil, and it has performed to our satisfaction. Prior to joining Mirae Asset I was a portfolio manager at the fourth largest investment company in Brazil.

Political & Economic Snapshot

3. What are the underlying factors that contributed to the recession in Brazil?

It was a mix of many factors. The end of the commodity cycle, which affected most emerging market countries, was certainly key. Moreover, excessive stimulus, using credit up to its limit to boost consumption instead of investments, along with harming the fiscal accounts were all to blame. In addition, the Central Bank of Brazil (BCB) was unable to reach the inflation target, increasing uncertainty in an already messy environment.

4. What do you see as the path forward for the interim Brazilian government following a protracted period of political crisis and uncertainty that culminated in the impeachment of President Dilma Rousseff?

President Michel Temer took office declaring that he was ready to give up the reelection trial in order to focus on the reforms that are deemed necessary in Brazil. Until now, the reforms have been implemented very well, with the Lower House approving the fiscal cap. It is expected the Senate will likely confirm the cap by the end of this year, with favorable odds that they will be confirmed. Following this, the approval of the social security reforms will be the next pivotal moment. Without it, pension expenditures relative to total budget will reach unsustainable levels within a few years, forcing the government to cut the pension payments or breach the fiscal cap.

5. How do you view the Petrobras scandal and its influence on policymakers?

The Petrobras scandal has surprised the public in recent years, but now measures have been taken to improve the health of the company. The CEO was replaced by a very well-known executive, a transparent price policy has been implemented and a cost-cutting program and sizable asset-selling plan are in place. These are only some of the many measures taken to restore confidence and repair the finances of the biggest Latin American oil company.

The Petrobras situation could be a game-changer in municipal elections, where the Worker's Party (PT) of Dilma and Lula suffered massive losses. The number of PT mayors elected plummeted 60% from 638 to 254, hinting at what could happen in 2018 presidential election.[1]

6. What buffers are in place to defend against future currency and economic shocks?

The improvement on current account observed in the last two years shows the Brazilian Real (BRL) is quite close to the equilibrium level. This by itself should reassure investors that it is unlikely the BRL will face new rounds of losses like those of 2015. In addition, it's important to remember two aspects: the current account deficit is now widely covered by foreign direct investments and the BCB is buying back all swap positions. It reached USD 107 billion during the risk-off period in 2015, has now fallen to about USD 25 billion, and is expected to be near zero by the end of the year.[2] Therefore, the BCB reserve position will probably return to the USD 360 billion level, which is above 20% of gross domestic product (GDP). Even with these important buffers, we believe the most important defense mechanisms are the government-driven reforms. Brazil has many opportunities and once foreign investors regain confidence that the country is back on track, investment sentiments will remain high for the long term.

[1] El Pais, "Second round of municipal elections confirms Brazil's sharp turn to the right "(November 2016)
[2] Bloomberg, Mirae Asset Global Investments (2016)

Outlook

7. What are your inflation and monetary easing forecasts in the wake of the BCB cutting the benchmark SELIC rate?

We expect inflation of around 6.9% this year and 4.9% next year.[3] With this retreat from the target, the BCB will be able to cut interest rates to 10.75% in 2017, before entering a watch-and-see mode. After that, it is very likely that the BCB will start a new easing cycle and bring the SELIC rate close to the historical lows of 7.25%.

8. There are signs of reviving confidence in manufacturing, services, and consumption. Do you foresee a swing to positive sentiment and growth for businesses and consumers next year?

In the short term the pace of recovery will probably be slow, given the necessary deleverage of the economy. This moderate recovery will enable the BCB to cut rates in a sustainable way, which should help improve the economy as a whole in the medium to long term.

9. What are the upside and downside risks to be considered?

The upside is the reforms that are in the process of receiving approval from the Congress. President Michel Temer has shown an impressive ability to keep the government base in the Congress united, and the strength of this base could be enough to approve any reform needed. Besides, service inflation could decelerate faster than expected, in response to the high unemployment rate. This could result in more aggressive cuts to the interest rate, helping to boost the economy and lighten fiscal deficits.

The downside risk is faster-than-expected inflation in the US, pushing the Fed to raise rates to attract flows that are now invested in emerging markets (EM). Consequently, we might face currency depreciation, which would halt the easing cycle of BCB in the short run. There is also political risk. Operation Car Wash, a money-laundering investigation, could extend to members of government, making approval of reforms more difficult.

10. Is Brazil's higher risk premium warranted and what investment opportunities are appealing in your view?

The biggest opportunity in Brazil lies in fixed-rate and the inflation-linked government bonds. Considering how negative the output gap is, Brazil's economy is likely to grow without pushing inflation in the next years. In this environment, real rates could go lower to between 5% and 6%, according to some market economists.[4]

11. What sectors and firms will emerge as winners in the medium to long-term?

We believe in the bottom-up analyses in the medium to long-term, so we favor companies with proven management track records. The most promising sectors are finance, consumer goods and services.

Portfolios & Investing

12. What is the consensus on the Brazilian equity index Ibovespa, which has performed well this year, following years of disappointment?

Most of the recent improvement in the economy is already priced into the Ibovespa index, but there could still be further enhancements in the fiscal situation or upside revisions in growth expectations in the medium term. Once the fiscal expenditure cap

[3] Mirae Asset Global Investments (2016)
[4] Bloomberg, Mirae Asset Global Investments (2016)

law legislation and the pension reform bill are finally approved, the GDP could be boosted by the rise in consumption. Those employed but who have lacked confidence in the economy will likely spend more. This is something that usually only depends on a better environment. It is very likely that this will be the first source of growth, especially given the size of the drop in the recent years. These are problems that can be solved, so strong retreats in the Ibovespa should be a “buy opportunity” from a long-term perspective.

13. What do you expect the Brazilian Real to do after appreciating more than any major currency this year?

We expect the BRL to become less volatile and stabilize at between 3.3 and 3.8 to the US dollar. While Brazil’s balance of payments has shown important improvements and the worst appears to have passed, it’s hard to imagine EM currencies will keep outperforming with US interest rate normalization.

14. How may investors protect themselves from elevated rates of inflation and volatility?

Products that can provide protection for investors in the long-term include NTN-B’s, which are Brazil’s inflation-linked bonds. They offer protection from inflation part and pay a coupon of real interest rate. On the other hand, when we pick a long maturity of these bonds, we must be ready to tolerate high volatility. In this environment, a multi-market fund could be a significant opportunity given that the portfolio manager can pick and choose, avoiding those investments without an interesting risk/reward profile.

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