Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

July 2008

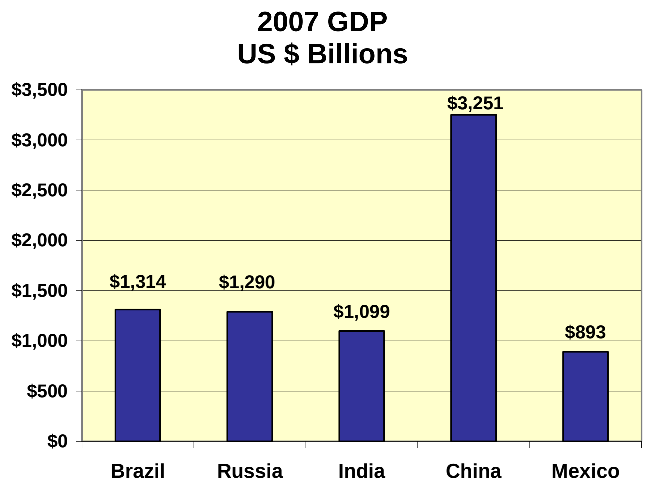
Brazil: The Best Investment in the BRIC Countries?

Brazil is not a serious country.
Charles De Gaulle, 1966

Brazil has found its path, and I believe that there is no way back. From here on, we will only improve.
President Luiz Inacio Lula da Silva, 2008

Five years ago, a team of global economists at Goldman Sachs led by Jim O'Neill wrote a paper entitled, *Dreaming with BRICs: The Path to 2050*. The thesis of the report was that the BRIC countries – Brazil, Russia, India and China – may well eclipse many of the richest countries of the world by 2050 and become the four leading global economies. In this trailblazing report, O'Neill predicted that China and India would become the dominant global suppliers of manufactured goods and services respectively, while Brazil and Russia would become similarly dominant as suppliers of raw material. It was a prescient analysis, as the BRIC economies have become the engines of global growth, affecting everything from the price of oil and iron to yields on U.S. Treasuries.

Over the past several years, we have written about both China and India in our quarterly market commentaries, and a small but growing number of our clients have asked us to allocate a modest percentage of their portfolios to investment opportunities in these stock markets. This quarterly commentary takes a look at Brazil. Because Brazil's transformation since 1995 has been less dramatic, its strong economic performance since the turn of the century has been overshadowed by China's and India's. Yet Brazil has been an excellent place to invest over the past decade with the Brazil Bovespa stock market index achieving an average annual return in U.S. dollars of 16% since 1998 compared with only 4% for the S&P 500 Index for the same period. Over the past two years, the Bovespa has also outperformed the other three BRIC stock markets, as Brazil has managed to avoid a major sell-off in 2008. Brazil's population of 190 million is the fifth largest in the world, and it has a land mass only slightly smaller than the U.S. and China. Few investors realize that it has a larger GDP than both Russia and India, as the following chart demonstrates:



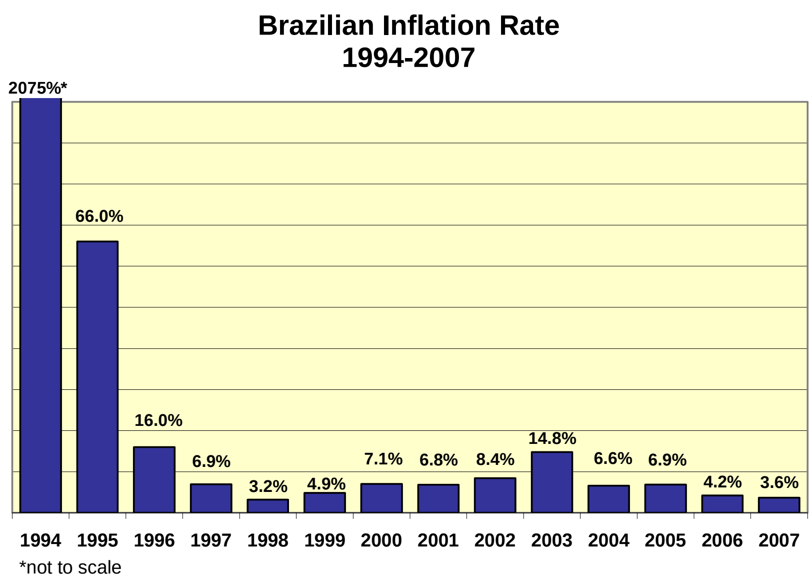
Source: International Monetary Fund

Brazil's Past

Colonized by Portugal in the 1500's, Brazil declared its independence from Portugal in 1822 in a bloodless coup. This is an important legacy, as Brazil avoided the destructive wars of liberation and bloody revolutions of many other South American countries. From 1822 until 1889, Brazil was ruled by Emperor Dom Pedro I and later his son, who was finally dethroned by a military coup. Although nominally a republic, Brazil was ruled by a series of military dictatorships for most of the 20th century. It was only in 1989 when Brazil completed its final transition to a directly elected government. Thus, although Brazil did function as a democracy from 1930-1964, its current existence as a true republic is less than twenty years old. The many military coups in Brazil's recent history have caused investors understandably to be cautious about committing funds to the Brazilian stock market.

Fernando Henrique Cardoso

Brazil's economic transformation really began in earnest with the election of President Cardoso in 1994. The son of a general, Cardoso chose an academic career, gaining a doctorate in 1961 in sociology. His left-wing views as a student and a professor caused him to be exiled from Brazil in the 1960's by the military dictatorship in power at the time. He taught in Chile, France and the U.S. before returning to Brazil. In 1986, as a Senator from the state of Sao Paulo, he helped to found the centrist Brazilian Socialist Democratic Party (PSDB). As the leader of the PSDB in the Senate, he also served as the Minister of Foreign Affairs in 1992-1993 before becoming Minister of Finance. It was in this role that he began the transformation of Brazil by introducing a plan to curb the hyperinflation which for decades had been the single most destructive force in Brazil's political economy. In June, 1994, the month in which Cardoso introduced the Plan Real (pegging the Brazilian real to the U.S. dollar), the monthly inflation rate was approximately 30% (2000% annualized). The chart below shows how the disciplined execution of Cardoso's Plan Real by his administration and his successor has slayed the inflationary dragon and brought fiscal stability to Brazil:

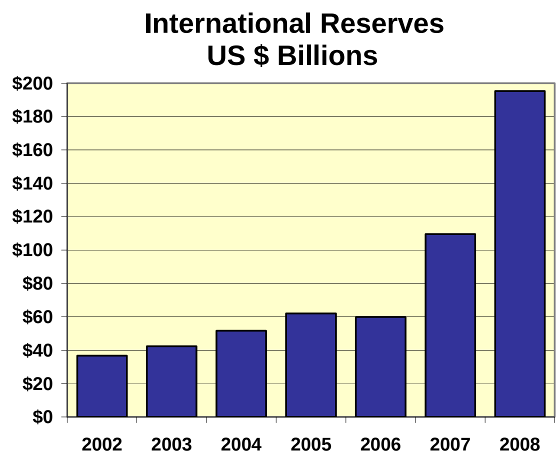


Source: International Monetary Fund

Riding the success of his financial reforms, Cardoso ran for the Presidency and was elected in October, 1994. He continued to fight inflation, reduce public sector spending, and reform social security and lower taxes. He presided over the most democratic and stable period in modern Brazilian history. A constitutional amendment was passed in 1998 to allow a President a second term to which he was promptly elected. It took all of his executive ability and fortitude to weather the storm caused by the collapse of the emerging markets in Asia in 1998-1999. With painful fiscal discipline, draconian interest rates, a 40% devaluation of the currency and a large loan from the IMF, Brazil was able to survive the crisis without defaulting on its international debt, as its neighbor Argentina did. Economic growth, however, ground to a halt, as can be seen from the chart of Brazil's GDP on the following page.

Luiz Inacio Lula da Silva

In 2002, with the election of Luiz Inacio Lula da Silva ("Lula") as President, many in Brazil believed that they had elected a president with a world view like that of Hugo Chavez, Venezuela's leftist-leaning President. The Brazilian stock market dropped almost 60% in U.S. dollar terms as the election played out in 2002. Lula was no stranger to Brazilian politics. Born in poverty, with almost no formal education, he lost part of his little finger as a worker at a sheet metal plant. At 22, he began his union career, encouraged by his brother who was a member of the Brazilian Communist Party. At the age of 30, he was elected President of the metalworkers union. Over the next years he organized and won a number of combative strikes, even being arrested once and jailed for a month. He was released on appeal. In 1980, he was one of the founders of the left-wing Worker's Party. Elected to Congress in 1985, he ran for President in 1989 and lost very narrowly. He ran again in 1994 and 1998, losing to Cardoso. However, when Lula finally won the Presidency in 2002 at the age of 57, it turned out that Brazil had elected a working class man of the people who embraced both democracy and economic orthodoxy rather than a Marxist like Hugo Chavez. Lula and his advisers had seen the value, especially to the poor, of low inflation and a stable, growing economy. He maintained the sound approach of Cardoso which included a floating exchange rate, budget surpluses (before debt payments), inflation targeting and central bank independence. And it has worked. Lula was re-elected President resoundingly in 2006, and Brazil has grown its economy so carefully and powerfully that both Standard & Poor's and Fitch's raised Brazil's national debt rating to investment grade earlier this year. The charts below show the growth of Brazil's international reserves and its robust GDP growth over the past years:



Source: Central Bank of Brazil

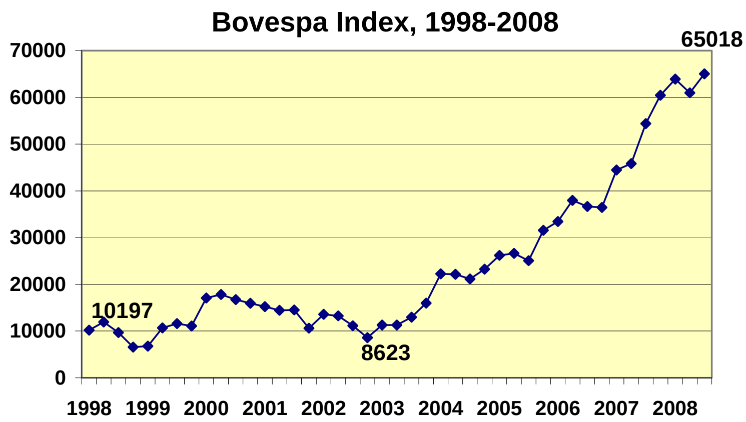
Source: International Monetary Fund

Energy Self-Sufficiency

Recently, Brazil has announced the discovery of some huge offshore oil reserves. The Tupi field alone holds between 5 and 8 billion barrels of oil and natural gas equivalents – an enormous addition to Brazil's proven reserves of 14.4 billion barrels. Initial estimates suggest that the entire pre-salt field may be much larger, containing 50 billion barrels or more. If recoverable, this would catapult Brazil into the top ten oil producing nations. Importantly, every well that has been drilled through the salt layer so far has struck oil. The technology to extract this oil and gas is truly extraordinary, as the fields are in areas where the ocean floor is up to 10,000 feet below the surface. Then wells of up to 20,000 feet must be drilled into the seabed through rock and salt layers in order to extract the oil. Reputable oil analysts believe that oil from these fields can be lifted at costs which will provide Petrobras and its partners an adequate return on investment. So there is little doubt that Brazil, which currently produces approximately two million barrels per day and is self sufficient but not a major exporter of oil, will join the ranks of exporting nations within the foreseeable future.

Brazilian Stock Market

The chart on the following page shows the excellent performance of the Brazilian stock market, especially during the period 2003-2008:



Source: Bloomberg L.P.

Weighing the Pros and Cons

The table below outlines some of the positive and negative aspects of the current situation in Brazil:

Pros	Cons
Abundant natural resources (iron ore, food, etc.)	Politically still a fragile democracy
Huge oil reserves	Uncertainty about Lula's successor
Large international monetary reserves	Widespread corruption
Rapidly growing middle class	Over-regulation of commerce
Transitioning to deregulated market economy	Poor infrastructure
Strong currency	Bloated public sector ownership
Major ramp-up of home and car ownership	Current account surplus eroding
Stable economic model	Modest increase in inflation

Conclusion

Brazil has clearly made remarkable progress over the past decade – both economically and politically. Its economy is growing faster than the U.S.'s, and its perennial curse of inflation seems to have been largely eliminated. After the 70% depreciation of the Brazilian real against the U.S. dollar between 1998 and 2002, the real has strengthened dramatically over the past six years, returning nearly to its 1998 level. Brazil now has a trade surplus as well as a current account surplus, and with the expected growth in production from its giant new offshore oilfields within five years, it is likely that Brazil, as an oil exporting country, will continue to build international currency reserves. Meanwhile, its iron ore and food exports are urgently needed by nations such as China and India. Finally, its middle class is growing dramatically, as regulations restricting automobile and mortgage lenders have been loosened so that more consumers can borrow to purchase cars and homes. The main challenges to Brazil's continued growth come on the political front. Will democracy, always a fragile flower in Brazil, grow into a sturdy plant which will withstand the constant economic and social vicissitudes of a developing nation? Will Brazil continue to elect such visionary statesmen as Cardoso and Lula? Have the dragons of hyperinflation and currency devaluation been slain for good? With the P/E ratio of the Brazilian stock market at approximately 16, many investors believe that it is prudent to wait until the current global bear market has bottomed before committing funds to Brazil. Whether the timing is good or not, we at Bradley, Foster & Sargent, Inc. believe that the Brazilian story is not over and that, having tasted the fruits of fiscal discipline and democracy, Brazil will not turn back. We plan to follow this high risk/high reward market closely to be ready to participate in the Brazilian stock market at a timely moment through open and closed-end mutual funds and ETFs. We are also monitoring the ADRs of individual companies, such as Petrobras (oil) and Companhia Vale do Rio Doce (iron ore), for possible inclusion in our portfolios.