GLOBAL X
by Mirae Asset

GLOBAL X INSIGHTS

Views From the Ground: Brazil

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In continuing our diligence on current holdings and future ideas, we recently conducted 31 meetings over five days across São Paulo and Rio de Janeiro, complemented by onsite visits and channel checks. We spoke with company executives, store operators, food delivery drivers, tax consultants, taxi drivers, and economists to develop a well-rounded view of Brazil's investment environment.

Key Takeaways

- Our recent trip to Brazil left us with an even stronger conviction regarding the attractive cyclical opportunity the country could present.
- Brazil is benefiting from its monetary policy easing cycle and could get an additional boost if/when the U.S. Federal Reserve begins to cut rates.
- We believe that Brazilian equities offer very attractive dividend yields and valuations at current levels.

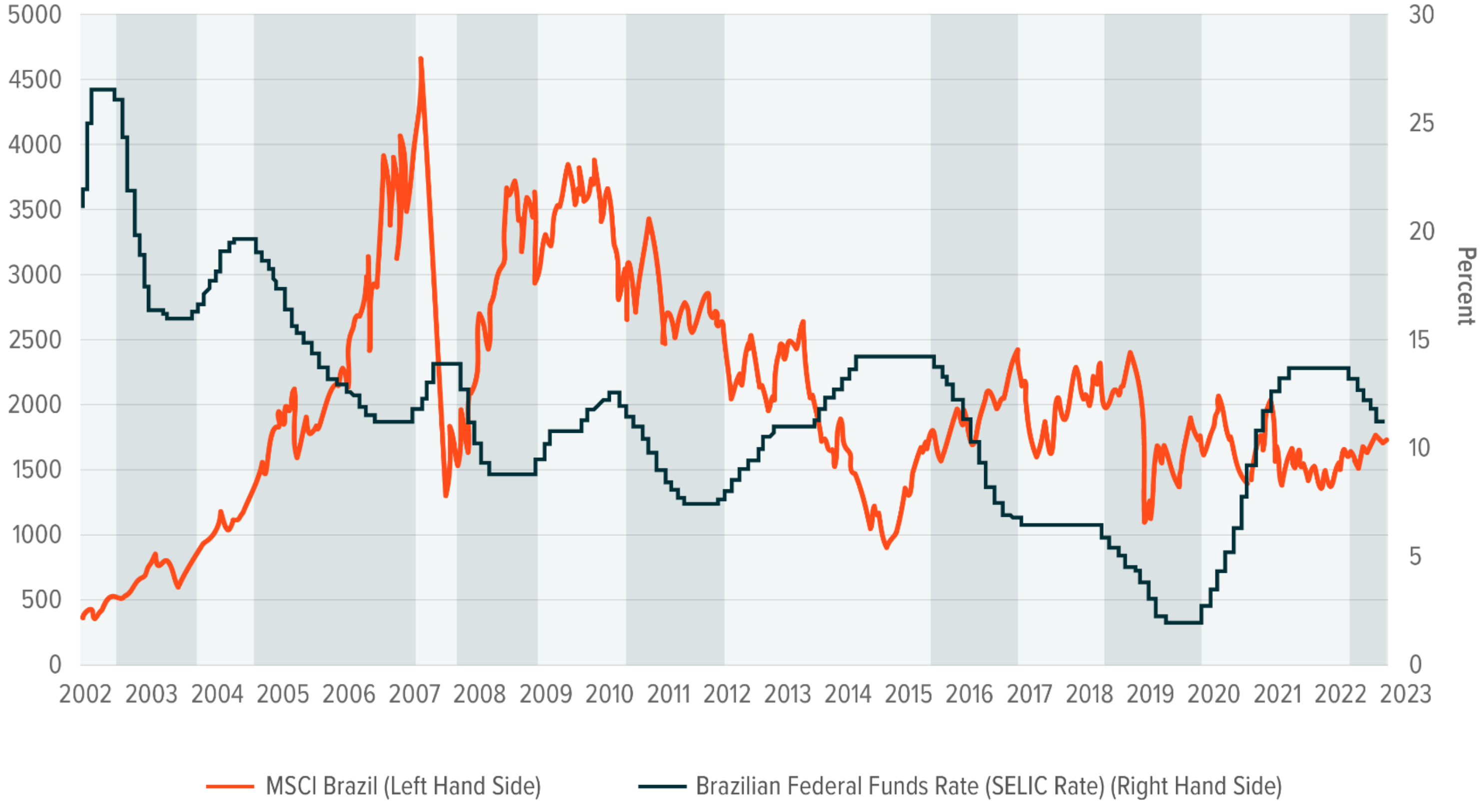
Brazil Looks Good. Fed Cuts Could Make it Great.

Brazil has positioned itself to perform well if/when the U.S. Federal Reserve begins to ease interest rates. Though, in the past, Brazil has found ways to get in its own way (via concentrated exposure to certain commodities, a lack of fiscal discipline, political corruption, or other missteps), we found that local executives feel Brazil is in a better position now than they've seen in decades.

- **Politics:** The local executives we met believe President Lula's market-negative bark has been worse than his bite. The "centrao" is maintaining a balance in congress and Fernando Haddad is performing significantly better in his capacity as Finance Minister than the market ever expected.
- **Reforms:** Brazil has gone through state-owned enterprise (SOE) reform, pension reform, central bank reform, fiscal reform, and tax reform over the past few years. The individual improvements are starting to move the needle and rating agencies are noticing, as seen by the S&P upgrading Brazil's credit rating to BB in December of 2023.
- **Monetary Policy:** From conversations with various economists, we believe that Brazil needs positive real interest rates to stand around 4.5% to keep the real (BRL) steady. Inflation has fallen to roughly 3.75%.[1] So, 3.75% plus 4.5% would give us a terminal benchmark interest rate of 8.25%. That means we could still have 300 basis points (bps) of rate cuts in front of us. For equities, the past cuts are as important as those likely forthcoming. The Brazilian Central Bank's rate setting committee, COPOM, has cut interest rates from 13.75% to 11.25% in recent months. Though it often takes time to see rate cuts drive improvements in loan growth, spending, and asset quality, these cuts make an immediate move in earnings expectations. Many corporate balance sheets are levered in floating rate debt, meaning that earnings reports are already beginning to show a reduction in net interest expenses, which supports net profits. In the past six rate cutting cycles, we've seen the MSCI Brazil Index (USD based) rally in four of them and move down in only two.[2] Importantly, those rallies have averaged roughly 96.7% upside, where the drawdowns averaged only roughly 17.3%.[3]

MSCI BRAZIL INDEX PERFORMANCE DURING PREVIOUS INTEREST RATE CUTTING CYCLES

Source: Global X ETFs with information derived from: Bloomberg LP. Data as of February 29, 2024.



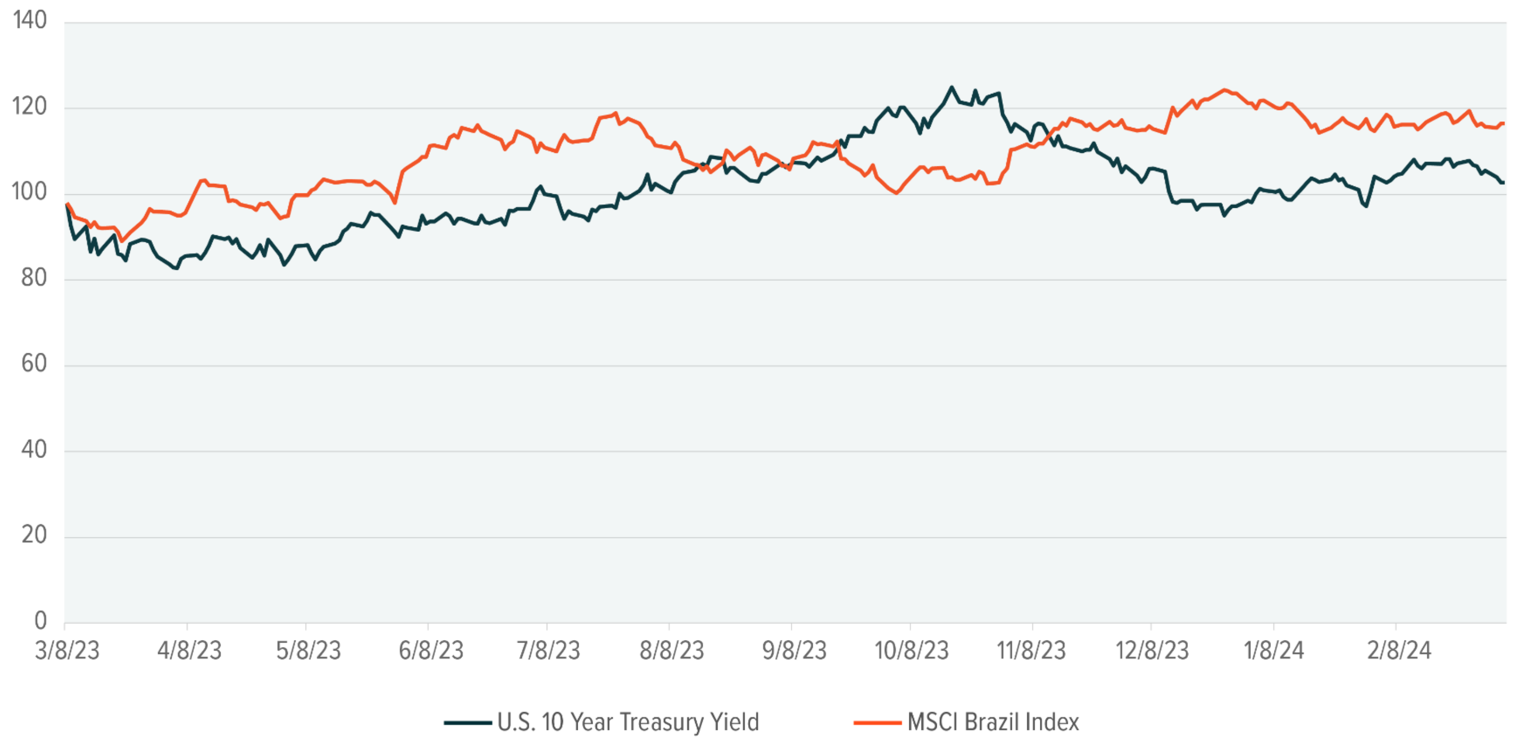
- **Flows:** Incremental flows could come from three sources:
  - **Locals:** Local investors could move from fixed income to equities as interest rates come down.
  - **Foreigners:** Foreigners could use Brazil as a "risk on" investment as the U.S. Fed begins to pivot.
  - **Technical:** Earlier this month, MSCI said foreign listings would become eligible for the MSCI Brazil Indexes starting in August. Such a move could result in USD 4.7 billion of inflows.[4]
- **Trade Surplus:** With an increasingly diverse export mix via growing exposure to agriculture and oil, Brazil's economy has grown less dependent on cyclical steel demand than in the past. Brazil is now the second largest exporter of food in the world (number one on a net basis).[5,6] Brazil is also a key exporter of fossil fuels. Brazil plans to expand oil production to the point of being the fourth largest oil producer in the world by 2029.[7]
- **Primary Fiscal Balance (which excludes interest payments):** Our meetings with a tax consultant put doubt on the chances for a meaningful pick-up in fiscal revenues this year. Thus, it doesn't seem like Brazil can reach a primary fiscal surplus for 2024, but we predict a primary deficit of 1% or less, which we believe is healthy enough to keep the BRL stable.
- **Valuations:** Brazil equities as measured by the MSCI Brazil Index trade at 7.8x earnings, 1.4x book value, and with a 7% dividend yield.[8]
- **U.S. Dollar (USD) Hedge:** Historically, Brazilian equities have rallied roughly 5% with each 1% move of USD weakness.[9]

In summary, Brazil looks inexpensive, reforms are helping, the Central Bank has done a fantastic job containing inflation, and the economic backdrop looks stable. We believe that global investors will come into Brazil in a "risk-on" environment (see the recent relationship with the 10-year yield below) and that local investors will move from fixed income into equities as the benchmark SELIC interest rate continues to drop.

It's difficult to time the U.S. Fed, but we think building a position now and sitting on a 7% dividend yield at depressed multiples until the Fed moves makes sense.

INVERSE RELATIONSHIP BETWEEN U.S. 10 YEAR YIELD AND BRAZILIAN EQUITIES (IN USD)

Source: Global X ETFs with information derived from: Bloomberg LP. Data as of March 6, 2024. Indexed at 100 as of March 7, 2023.



A Game Changing Digital Backdrop

In the past few years, Brazil's Central Bank has developed and rolled out a national digital payment system called Pix. With more than 160 million users, Brazilians use the system more than they do debit and credit cards.[10] Pix allows people, companies, and government institutions to send and receive instant payments to each other 24/7. This system links up across all banks in Brazil, so you can open your normal banking app and click on PIX. Within that next page, you can send or receive payments via QR code (more common for store or restaurant transactions) or instant payment (by putting in the receiver's phone number, name, or tax number). This initiative is improving the backdrop for business by:

- Increasing competition and reducing fees from incumbent banks
- Promoting financial inclusion
- Creating more transparency
- Increasing tax collection
- Increasing convenience and security

Before Pix's launch, roughly 30% of the population didn't have a bank account.[11] That number has almost halved to 16% since the launch.[12]

Company Spotlights

Vivara: Vivara is Brazil's leading jewelry company, with a trusted brand and over 60 years of delivering aspirational goods to the Brazilian consumer. In a fragmented market, Vivara leads with over roughly 19% of Jewelry market share across two different brands, making sure they have an aspirational outlet to different levels of the Brazilian population.[13] We believe Vivara offers the opportunity for steady margin compounding based on:

- Advantages in working capital: Unlike apparel companies, jewelry companies do not need to discount products to clear excess inventory. Lesser selling products can be melted down and remolded into new products.
- A flexible model: Depending on the price of precious metals, Vivara can increase or decrease the amount of gold/silver used in each product.

- Low price elasticity: The average consumer does not follow the prices of precious metals, leaving room for margin consistency. In addition, as many purchases are special/event driven gifts, the consumer does not typically push back on prices – especially given trust around the brand.

Last, Vivara benefits from a long-term contract with Gisele Bündchen as a brand ambassador, providing a deep level of brand awareness and trust.

Nubank: Nubank is the largest digital bank in the world outside of Asia.[14] The company boasts over 90 million clients across Brazil, Mexico, and Colombia.[15] Given its lack of physical footprint, NU carries a significant competitive advantage in its cost to acquire, cost to serve, and cost to fund. It is also known for its best-in-class user experience, strong brand recognition, proprietary technology, and unmatched scale. The circular business model relies on customer experience → more customers → more engagement → more data → lower costs → lower fees and higher rates → better customer experience. The company is still in the early stages of growth, and we see ample opportunity due to Latin America's underbanked population and its relatively high internet penetration. We see Nubank's entrance into new segments, such as payroll loans, mortgages, and brokerage, as inevitable and representing significant cross-selling opportunities and operational leverage.

WE CONDUCTED 31 MEETINGS OVER FIVE DAYS, INCLUDING AT NUBANK

Mercado Libre: Mercado Libre, known as the “Amazon of Latin America,” operates the region’s leading online marketplace, along with other fast-growing businesses, including payments, logistics, and advertising. The company boasts a strong competitive advantage in infrastructure and distribution, allowing it to offer attractive perks and low costs versus peers. From a top-down perspective, Latin America represents an attractive market based on low banking penetration, a tech savvy population, and a growing middle class. This is a pan-Latin American story, but Brazil and Mexico drive most of the company’s earnings. We see these markets as especially attractive, with real wage growth and falling interest rates likely sparking consumption and credit acceleration. We believe Mercado Libre can leverage the success of its online marketplace to expand into other verticals. These other business lines are not only attractive standalone opportunities, but also act as traffic drivers for the marketplace, further driving gross merchandise volume (GMV) growth, and deepening moats against competition.

ADS FOR MERCADO LIBRE WERE A COMMON SIGHT IN BRAZIL

GLOBAL X PRESENCE IN ALL CORNERS

Conclusion

Overall, we left Brazil with a renewed sense of optimism in regard to the strong cyclical growth opportunity we see in the country and believe our active process offers a strong approach to gain exposure.

Footnotes

1. Bloomberg LP. Data as of March 7, 2024.
2. Bloomberg LP. Data as of December 31, 2023.
3. Ibid.
4. Bloomberg News. (2024, Feb 13). MSCI Move May Trigger $4.7 Billion of Inflows Into US-Listed Stocks Stocks by Brazil Firms.
5. Atlantic Council. (2024, Feb 14). Brazil Aims to Advance Its Bid For Leadership of the Global South Through Food Security.
6. U.S. Department of Agriculture Economic Research Service – Amber Waves. (2022, Sep 27). Brazil’s Momentum as a Global Agricultural Supplier Faces Headwinds.
7. Oilprice.com. (2023, Nov 29). South America’s Offshore Oil Boom Will Challenge OPEC’s Dominance.
8. Bloomberg LP. Data as of March 4, 2024.
9. Global X ETFs analysis of data from Bloomberg LP. January 1, 2003 through December 31, 2023. Data accessed on January 16, 2024.
10. Bloomberg News. (2024, Feb 27). Brazil’s Wildly Popular Instant-Payment System is Going Global.
11. Ibid.
12. Ibid.
13. Vivara. (2023, Sep 30). Corporate Presentation 9M23.
14. Nubank. (2024, Feb 22). Q4 2023 Earnings Presentation.
15. Ibid.