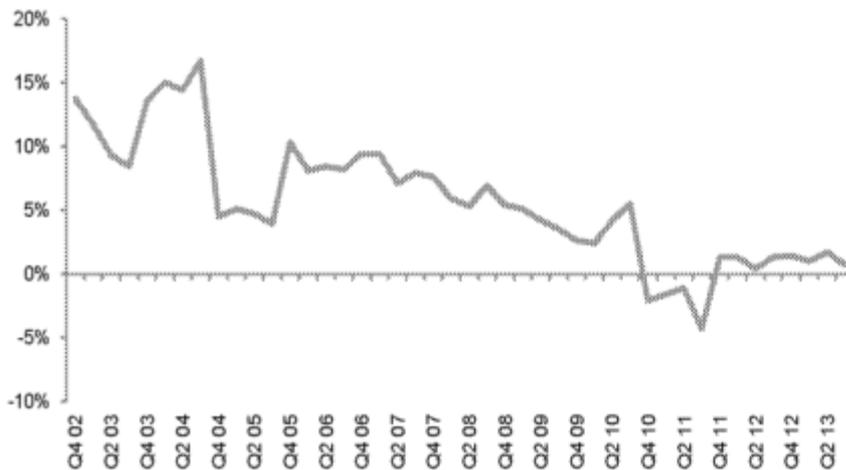




Figure 59: Brazilian non-financials - FCF/Sales (%), Rolling 12m average



Source: Deutsche Bank, Bloomberg Finance LP

The negative impact of government policies on the economy is likely to continue to emerge on both a micro and a macro basis in 2014. DB economist Jose Carlos de Faria expects lower growth, mainly due to the continuing reluctance of the private sector to invest as the impact of heterodox state-led policies has undermined business confidence and created distortions which cannot be easily unwound. The full fiscal impact of the big expansion in lending and market share by the three big state controlled banks will only become fully apparent over the medium term. Meanwhile, we would expect consumption to come under pressure in 2014 and for employment levels to finally begin to rise in a meaningful manner. If slower growth in China puts further pressure on commodity prices, as we expect, the multiplier effect on Brazil could be significant in terms of fiscal revenues and future FDI inflows to finance the current account deficit. Against this backdrop, the Real is likely to further depreciate against the US dollar.

Notwithstanding the very poor fundamentals, we need to beware of a repeat of what has happened to equities in Argentina over the course of 2013 where a rise of nearly 50% in US dollar terms has occurred despite the further deterioration in the immediate political and economic situation. As with Argentina or Russia, the asset valuations of the more cyclical and state controlled companies are very low which makes them an option-like play on any improvement in risk appetite. We believe that such a scenario is unlikely to happen in Brazil in 2014, because there is no real indication of an inflection point in government policies as yet, although the market could experience very sudden sharp upwards moves if the opinion poll ratings of the PT and Rousseff deteriorate – the World Cup may have a part to play depending on Brazil's performance as host and the performance of the national team on the pitch. For the time being though, we remain underweight in Brazil as we expect both the domestic and the external environment to remain unhelpful, a view which is reinforced by the difficulty in finding stocks which combine attractive fundamentals with reasonable levels of valuation.