

Brazil Focus and BRIC Update

4 December 2009

Allianz 
Global Investors

In brief:

- Our recent research trip to Brazil revealed that domestic demand remains both resilient and strong
- Brazil is exhibiting stronger than expected economic growth and has weathered the financial crisis better than many market spectators had anticipated
- The 2010 outlook for the BRIC economies remains positive



Michael Konstantinov
CIO Emerging Markets,
RCM, and Manager of
the BRIC portfolios

The following are highlights from a conference call hosted by Michael Konstantinov on 4 December 2009

A recent research trip to Brazil

On our recent research trip to Brazil we visited about thirty companies in Brazil from many sectors and came back with a very bullish view on the medium to longer term outlook. This rests mainly on three pillars:

We have encountered very resilient and strong domestic demand which has only temporarily been affected by the global financial crisis. The reasons for this include a very solid financial system, as mentioned previously. The banking system only temporarily started to take away credit supply from the economy but since February or March of this year this has been restored, and we're seeing credit growth around the 20% mark. This is very much owed to the retail space. We are seeing domestic demand and consumption being driven partly by continued credit growth, which itself is made possible by the fact that we have seen real wage growth in the range of 3% to 5% p. a. over the recent years. In addition, unemployment has come down substantially. Despite a short blip experienced during the financial crisis, this trend has continued over the last months, and the overall employment pool has grown.

We are seeing a very favourable environment for the consumer, who now for the first time for decades can borrow money at low interest rates. Real interest rates are only 5% as of today, against 10% a year ago, and three to five years ago they were in the 20s. We believe this is a very powerful combination which is driving the Brazilian economy into a strong recovery. Expectations for GDP growth are now in the range around 5% for next year, after the economy has been more or less flat this year, which is much better than the very sharp recession that was expected by most analysts at the beginning of this year.

This is one of the main pillars as mentioned previously, and it is at least as strong as it was before the global recession.

Some promising investment opportunities: stock examples

Among the companies we visited, I'd like to point out two names: one is Localiza, the car rental company, already known from previous updates. We have already presented their reaction to the difficult economic environment at the end of last year, where they basically reduced the pace of growth so that they could finance their ongoing business with their internal cashflow generation. Since about the middle of this year they have started to resume growth, as most of

their smaller competitors are in a very difficult financial situation. This includes the number two competitor, who has previously been competing with Localiza quite fiercely on the pricing side and will now probably go into Chapter 11 in the relatively near future. As a result, Localiza is gaining market share very rapidly from all players, and they already have around 30%. For the next year they are talking about internal growth of around 35% for the next year. If that is the case, they can grow on top of the market growth, estimated at around 20% for next year, by an additional 10% or so. To sum up, the stock story is panning out even better than expected, we have been holding it for a while and it remains a core holding.

Another example from our portfolio is Brazil's leading dental insurance company, Odontoprev. This is another market leader, with a low-cost business model with very high returns. Although the overall market is underpenetrated, because dental insurance is not yet available to everyone, the rising middle class is driving demand in that direction, so the market is growing. Last year they had strong competition from their number two competitor, which was associated with one of the biggest banks, Bradesco. However, while we were in Brazil, one day after we met the management, the company announced a merger with the number two player, with the company remaining the managing company in the merged entity. They will be using their business models, technology etc. and will have access to the large corporate and retail client base of Bradesco, providing new leverage for their business model in these sales channels. It's a win-win situation for both, and the pricing pressure from the competitor has gone. This is another good example for a company driven by the demand coming from the growing middle class, but also by consolidating a fragmented sector with a good business model. These two examples illustrate what can be done besides pure consumer plays, where you can buy in expanding retailers or in the banking sector, which is also thriving on grounds of the rebound in economic activity.

Foreign direct investment

Another pillar for Brazilian growth is foreign direct investment (FDI). This has been held back by corporates, certainly last year and into this year, because of the uncertainty coming from the global crisis. But in the last two or three months we have seen the investment cycle coming back into steam. Here we are talking about very broadly based infrastructure investments, which are certainly

needed and partly supported by the government. Even more than that, we are talking about investments by corporates into expanding their businesses. With the whole economy expanding there is need for new trucks, machines, new plants etc. This is not yet fully reflected in some of the earnings forecasts by investors and analysts. I believe this could be one further leg in the overall growth story for Brazil.

However we remain realistic, and while positive on the medium and longer term, we are also aware of the risks out there. I'd just like to point out the main ones. Next year is an election year, and in the past elections have not been too positive news for the Brazilian equity market, because of the increased uncertainty. However, there is a big difference this time: the first is that the present government is very popular, Lula has probably the highest popularity for a president who is in the last months of his second term (around 80%). Even if there was a change in the government it would be a change away from the most left-wing party in the political spectrum, towards the centre-right. Therefore I would not expect a change in the major direction of the economic policy, and I am not particularly concerned with respect to this year's elections.

Monitoring the real

Another risk is the strong real. For those who have followed the Brazilian economy for a longer period this is an extreme change, because historically the weak real was the main threat to the Brazilian economy. With the very sharp falls in the value of the real we have typically seen sharp inflationary pressures popping up. Basically this time it's the reverse: because of the very positive outlook for Brazil and the way the country has made it through the crisis, we can now see that many investors are attracted by Brazil. Despite the economic crisis we have seen foreign direct investment of \$30bn this year. So after China, Brazil is now the second most important destination of FDI worldwide. At the end of the year we'll probably see somewhere around \$35bn, after a record year of \$45bn in 2008. Clearly an important driver. This also shows the confidence of corporation around the world, putting their money into Brazil on the long term. On top of that there are portfolio investors, such as us, who are investing into Brazil. All taken together there are substantial inflows into the Brazilian economy, putting appreciation pressure on the Brazilian real. The high commodity prices, of course, have their share in this as well.

To conclude, the currency has to be monitored. Because of improved imports, we will probably see a change in the current account position into a – small – deficit, which can easily be financed by these inflows and will somewhat relax the appreciation pressure. If the real would appreciate another 50%, as it has done over the last two years, it would put pressure on the industrials sectors and on exporters, which would be less positive.

Inflation

Inflation continues to be one of Brazil's big success stories. Everyone remembers that Brazil was a hyperinflation country in the nineties. Now, inflation has come down to 4%, and is expected to go up to only 4.5% during the next year. The main driver of this has been a very responsible monitoring policy over the past years. This has also caused the real interest rates to come down substantially. It has also been supported by the strong real which has caused import prices to fall.

We don't see inflation as a short-term problem. It could become an issue once we reach full capacity utilisation. In this context, it is important to see an investment cycle beginning in order to have sufficient capacity to meet the increased demand coming out of the Brazilian economy.

For the next six to nine months we are not too concerned. We might see the central bank tightening their policy a little bit, but this would be a precautionary measure to protect the economy from inflation coming up.

Outlook for the other BRIC regions for 2010

Valuations and earnings growth

As a starting point we should look at valuations and earnings growth. We are talking about valuation levels for 2010 which remain at the midpoint of valuation ranges in all four markets, ie. they are neither expensive nor cheap.

However, expected earnings growth for these countries is in the range between 25% and 50%. The latter applies to Russia, because the country saw the largest decline in earnings this year. With the recovery in commodity and energy prices, the rebound for the Russian equity market will be the strongest. There is a strong cyclical element here.

In the other three markets we are somewhere in the mid-20s range. From that point of view it remains

a very attractive asset class, despite the strong run we have seen this year in the equity markets. We should not forget that this year's rebound had two reasons: last year's decline, and the fact that BRIC markets were much less affected by the crisis than expected, and that last year's sharp sell-off was reversed quickly once investors realised that the situation was not that bleak. Throughout the year we have seen increased growth and earnings expectations.

Going forward, from a risk-reward perspective these markets are still very attractive and show strong earnings growth combined with the existing valuation. With respect to drivers, Russia remains clearly dominated by the energy sector and therefore by the oil price.

However, we believe this time we will have an additional driver for the market, which is very strong disinflation. This is something only very few people talk about, but over the recent months we have seen a much stronger decline in inflation expectations than previously thought. This is partly a result of central bank policy, and partly helped by the recent strengthening of the ruble. Clearly it is also the result of the fact that in there is a lot of spare capacity, and with that pricing power is basically non-existent, real wage growth has halted, and therefore inflation is coming down much more quickly than expected into single-digit territory. With that, the central bank will be able to lower interest rates even further, which would provide a similar scenario as in Brazil over the last years. Also, over the next year the consumer should recover from the slowdown.

In addition to the oil price, this could be an additional trigger and we are trying to position the portfolio for this part of the outlook.

Revaluation of the markets

At the end of last year, we saw extremely oversold levels, leading to the MSCI BRIC having grown 63% year-to-date, with the BRIC OEIC up 75% and the SICAV 81%.

For example, Russia was trading at a PE level around 3, and although we have seen earnings downgrades throughout this year, the PE levels have by now gone up to around 8 to 9. So there has clearly been a revaluation of the markets, in addition to other factors. If you look at the longer-term valuation range, over the last three to five years, all four countries are now trading somewhere in the mid range.

As another example, for the Chinese equity market in 2007 saw a very strong run, and it started to trade at PE multiples of around 25x to 28x. With multiples around 14x we are now still very far away from that, but at the end of last year, China was in single-digit territory too. Despite the recovery, we should not forget that we are still 40% to 50% below the peak we saw in 2007, and we are presently in a very comfortable situation.

Questions

Once the Fund has reached the top range of valuations, how could you protect the value of the portfolio?

We would look from a bottom-up angle at the individual companies, as there are always parts of the markets which are more attractively valued, so we would start to steer the fund into a direction where we still find value. Another step that we have explored in the past is that can we invest up to one third of the Fund in non-BRIC equities, especially companies which are connected to the trends and prospects of the BRICs but not domiciled there. This would open up a whole new investment universe and could be a way we could diversify. We still believe that in the medium to longer term we would still be in growth territory in the BRICs. We have to remind ourselves of the fact that the crisis did not originate in the emerging markets but in the developed world. What became visible this time is that BRICs, while not completely decoupled, were able to counterbalance the negative trends and are coming out of the crisis relatively strong, and continue to grow. The longer-term growth prospects should also lead to earnings growth which should be able to mitigate potential overvaluations.

How do you protect investors from the different reporting standards, for example in Russia?

We typically apply a larger risk premium for Russian investments, which is also reflected in the fact that Russia is currently still the cheapest of the four markets, trading at around 7.5x to 8x PE against e.g. 14x for China or India. This would be our main adjustment. Of course there are individual companies with worse corporate governance and those with better governance, but many of the large companies have now moved to IAS (International Accounting Standards), so from that point of view we are getting figures which can be compared better in an international

context. However, we are still aware of the huge discrepancies, and we take these into account in our risk premia.

What is your current view on India?

India is the most interesting consumer story of the four, partly because of population: we're talking about a middle class of 300 to 400 million. We have similar numbers in China, but in India they have been using much more financial mediation to drive consumption. Debt levels of consumers have gone up, but they are still far below international levels. The huge domestic economy is the dominating sector for GDP, exports make up only about 6% of GDP. Also, the rural areas, which are growing more quickly, are much more dependent on domestic themes. Therefore India for us is probably the market that is least affected by the global environment, and as such, it is a more defensive market.

We are currently underweighting India. The main reason for the time being is the fact that India is less tied into the global economy and has a different monetary cycle. So the central bank has tightened monetary conditions much earlier than other economies, at the end of 2006, and then mid of last year went into very expansionary mode. We are now seeing inflationary expectations picking up, on top of which we saw very strong growth in Q3.

So, we are seeing a combination of a strong growth rebound combined with inflationary pressures building up, and we expect monetary measures to tighten a bit, not too aggressively, but they will be the first central bank among the BRIC markets into a tightening mode, and therefore we are presently slightly cautious. We see this as a positive development, however, because the central bank is acting pre-emptively in a very healthy banking sector, the outcome of which will be smoother and prolonged growth. To sum up, the valuation is around average, growth is around 25%. There might be positive surprises coming from the more positive growth environment, but we are expecting a tightening monetary policy.

Disclaimer

Issued by Allianz Global Investors (UK) Limited, authorised and regulated in the UK by the Financial Services Authority.

This information is for professional advisers and should not be given to retail investors.

The opinions expressed here are based on information which we believe to be accurate and reliable; however, these opinions may change without notice. The information contained herein, including any expressions of opinion, is for information purposes only and is given on the understanding that anyone who acts on it or changes their opinion thereon does so entirely at their own risk.

Details of the specific and general risks associated with our funds are contained within the Simplified Prospectus. You should always read this before investing. For a copy visit www.allianzglobalinvestors.co.uk or telephone 0800 84 84 94. Past performance is not a reliable indicator of future performance. You should not make any assumptions on the future on the basis of performance information. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations, and you may not get back the amount originally invested.

. J131729.