

FCL*Capital*

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Brazil: the bull case

According to Buddhist legend, Siddhartha Gautama, who would someday be known as the Buddha, was born a prince, in wealth and comfort beyond wildest dreams, not even knowing what poverty, disease and sadness were.

After a while, dissatisfied with the pursuit of fleeting pleasures, he set out in search of a deeper, more enduring truth. He and his followers entered a period of extreme ascetic practice, depriving themselves of food and sleep, bringing themselves to the verge of physical collapse and only eating fallen fruits, given to them by nature.

Folklore has it that once in a sunny morning a beautiful girl from a nearby village, while walking nearby, offered Siddhartha a basket of fruits while he was meditating beneath the shade of a big tree. Some of his followers, it is said, were deeply hurt by what they felt was a renunciation and a betrayal of the vows they had made: to live a life away from any pleasure and comfort.

Siddhartha, meanwhile, had one of his most important insights: the Middle Way. According to this principle, which became part of the Noble Eightfold path, the Middle Way was not a compromise. On the contrary, it was exactly the harmony that glues and holds together life's many contradictions. It was, in other words, part of the road to enlightenment.

Brazil, as all of our investors known, has been going through some dramatic times. We think the middle way story is a useful reminder that investors, when judging the country responsible for the "B" letter in "BRIC", should avoid extremes in their frameworks and their judgments.

For asset managers like this house, Brazil is a fascinating observatory. Navigating Brazilian markets, or, even more simply, just observing daily life in Rio or Sao Paulo streets is observing almost everything that makes the global economy ticks: sitting in a time zone between the US and Europe and with habitants in its population that range from the global elite to the very global bottom, the country is an amazing laboratory. From last model and yet hard to find tech gadgets in the US, to solutions and ideas made for “the bottom of the pyramid” that are usually present in Kenya or India, Brazil is, if anything, a very versatile country.

This is a rarely talked about comfort of living in a middle-income country with almost no middle income people. Maybe more so than any other country, there are points of contact with just about any idea, situation, product or reality in this diverse and vibrant place,

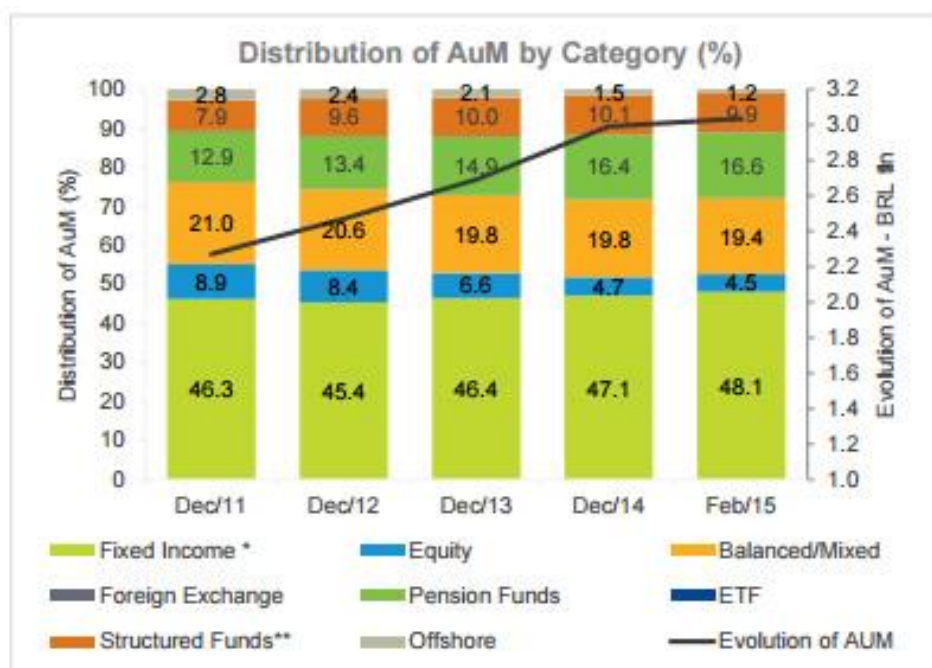
The problems and idiosyncrasies of this place are also not new. Respected “brazilianist” Thomas Skidmore once noted that people tend to be bipolar when it comes to emerging markets in general and Brazil in particular: it is either the country of the future or a hopeless place.

A possible explanation, we would argue, is that an environment of corporatism, statism, combined with chronic fiscal and managerial problems that made this country a permanent champion of high interest rates ensured that, over the decades, strange customs and biases began to form.

When investing their money, Brazilians tend to prize liquidity and safety in detriment of returns more than financial literature would suggest when adjusting for factors like income, age and wealth. Even more important, the Brazilian population, not only when it comes to investing but also in almost any circumstance and routine, tends to

have a very short-term bias. Putting it in more bluntly terms: we Brazilians discount the future a lot. What matters here is the short term.

This short-term rule is seen in assets under management in our fund industry (heavy bias to short-term fixed income products), government policies (fiscal irresponsibility), management practices, and many, many more instances.



Source: ANBIMA.

One additional (but certainly not exhaustive) consequence of our short-term bias: we tend to have a binary mentality that Skidmore once pointed out.

Markets, as we all known are made of cycles. An even better analogy may be the pendulum that Howard Marks uses: sometimes the pendulum swings too far to one side and the simple laws of gravity

dictate that eventually this “borrowed time” robbed from the other side must give space.

As in physics, so in markets, so in life. In the not so distant year of 2011, in one of the letters this house is most proud of, our October 2011 letter, this manager noted:

“On a subject that we will develop and analyze more deeply in future letters, we believe that the year 2012 has a good chance to be the opposite of what were the last years. Instead of bad winds blowing from the outside and a very healthy Brazilian economy, we fear the opposite situation: the rest of the world out of the crisis and Brazil beginning to show more clearly signs of exhaustion of your model.

The fact is that in recent years, not only structural reforms in the economy practically parked, as invincibility climate fueled by politicians was created, as if Brazil were an oasis, one holy grail of world economy with which the rest of the world would have to learn, he came into vogue in the country.

This is usually foreshadow ruin. We are not here predicting a crisis for Brazil. The country's economy is still quite healthy, especially if compared with the peripheral nations of Europe. But some warnings already loom on the horizon: central bank abandoned its inflation targets, statist and protectionist government, high spending, a business environment that remains very bad, a real estate bubble that took the two largest cities in Brazil and does not make any sense and will burst causing many losses, and more.”

Even more interesting than a correct prediction of the direction is the fact that in a market that works in a binary way where investors are permanently in glass half-full or half-empty mindset, many interesting nuances and dynamics are usually lost.

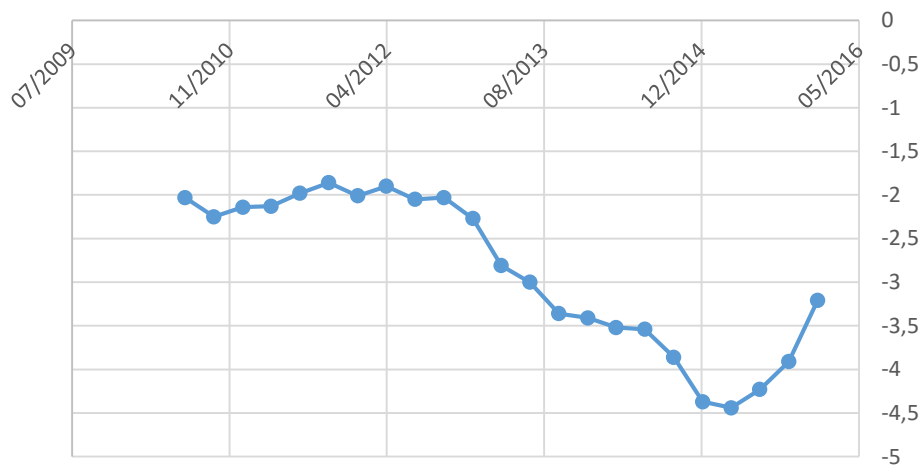
The thing that worried us the most back in 2011 was a general overvaluation in the level of assets (especially real estate as we noted, but also the stock market) and, very especially, a much-overvalued exchange rate. Indeed, we dedicated many of our letters in the 2011-2013 days to argue how expensive Brazil was and how overvalued and flawed the real was as a currency.

Currencies should not be afterthoughts for investors: they are one of the most important prices in an economy and their levels dictate the rhythm of the market.

For the first time in many years, we think the current level of the Brazilian exchange rate (around R\$ 3,50 per US\$ at the time of this writing) more or less is justified by the current fundamentals of the Brazilian economy, its exports, its current account prospects and obviously the return investors demand to hold the currency

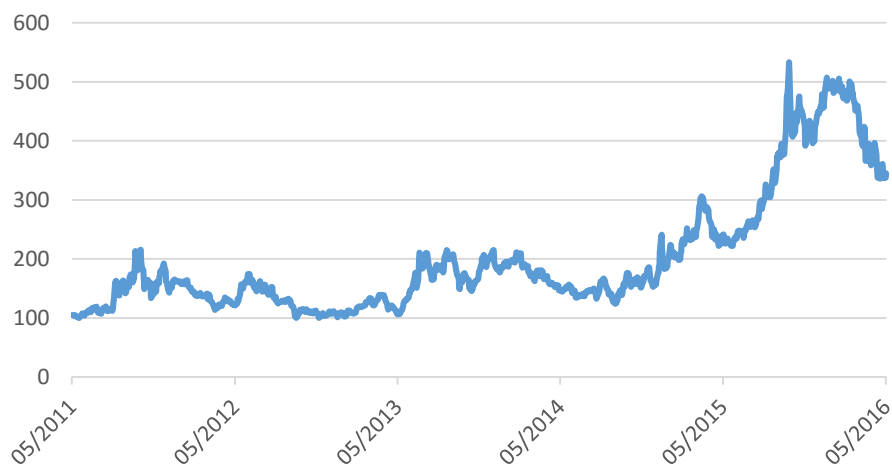
It took a lot of time for investors to realize this dynamic. They were so (rightly) depressed by the incompetence of the current Brazilian administration that they could not allow themselves to notice a positive development in the Brazilian economy. But the Brazilian current account did indeed go through a revolution in the past 24 months

Brazil's current account, past 5 years

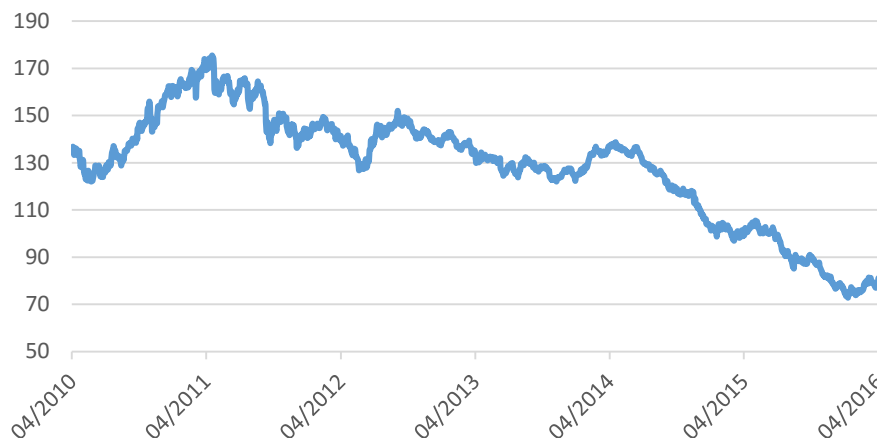


The only thing investors seemed to care about were short-term political news, daily fluctuations. In other words, a fixation on the trees but not the forest. Some predictions were very close to ridiculous: one bank analyst was on the record for Valor Newspaper claiming that one dollar should reach a peak of 4,17 reais per dollar around September 2016 (this was written in December 2015) and by the end of this year should trade at 4,14.

Brazil's Risk Index, Last 5 years



Commodity Prices, Last 5 years



Obviously, a miracle could happen and he could be right. However, in times like these we are proud to be disciples of the Graham-Dodd-Buffett tradition of long-term value investors. We like to look and try to understand the big picture.

At the same time, investing is a tough and interesting field: it does not allow too much for sacred beliefs and ideologies. It is a complex mechanism and therefore investors in their glass half-empty mindset mostly missed this current account revolution. High interest rates, short term thinking, we once again discounted to the future.

This means that, compared to most measures of fair value, like its purchase power parity, the real is no longer an outlier among emerging market currencies. It seems to have found its place, given its yield, risk, characteristics, and so on.

Country Spot	Iso
South Korean Won	-24,8472
Singapore Dollar	-28,3537
Philippine Peso	-28,7762
Turkish Lira	-32,5995
Brazilian Real	-32,7134
Hungarian Forint	-33,1482
Chilean Peso	-35,8579
Thai Baht	-37,874
Czech Koruna	-39,4729
Mexican Peso	-44,4677
Chinese Renminbi	-45,1046
Hong Kong Dollar	-48,3204
Colombian Peso	-48,4107
Polish Zloty	-48,6637
Indonesian Rupiah	-54,3544
Argentine Peso	-61,1846
Russian Ruble	-61,2058
Malaysian Ringgit	-61,6517
South African Rand	-64,5759

Country currencies compared to Dollar in Purchase Power Parity.

Source: Bloomberg.

Overall, we would argue that the dollar it is the currency we now worry about. Excessive dollar strength is part of the explanation in many of the current anomalies we see now in world financial markets, from low commodity prices to emerging market pessimism. Meanwhile we think investors are making a huge mistake betting on a Renminbi devaluation. But this is a story for another letter. Back to Brazil for now.

Since the excessive optimism gave way to total pessimism we tried to study Brazil from an outsider's perspective and just compare it to its regular competition (not the US or Germany, we would not be

that ridiculous. Instead, we took five other big emerging markets. In this letter, we will compare Brazil and its fundamentals with these five crucial competitors: Mexico, China, India, South Africa and Turkey.

The objective of this analysis will be to reach an assessment of what is, if any, Brazil's rightful place in emerging market's constellation. Has it really lost its way? Does it still has bright days ahead once this turmoil passes?

Brazil has well known competitive advantages: its land and mineral resources, coupled with its intensive agribusiness knowhow is unmatched. The result is an agribusiness superpower. At this house we hold major positions in Minerva (beef slaughtering), and Fibria (pulp), both of them with the backdrop and belief that no other place in the world will match its power in the relationships between agribusiness and commodities processing and exporting.

Brazil – 5 biggest companies		
Company	Operation	Market Cap (US\$ Bi)
Ambev	Soft Drinks	86
Itau	Financial	49
Petrobras	Oil & Gas	42
Bradesco	Financial	40
Vale	Mining	25
...Mexico – 5 biggest companies		
Company	Operation	Market Cap (US\$ Bi)
America Movil	Telecom	45
Walmart de Mexico	Supermarket	42
Fomento Economico	Consumer Staples	31
Grupo Mexico	Materials	18
Coca Cola Femsa	Consumer Staples	17

Turkey – 5 biggest companies		
Company	Operation	Market Cap (US\$ Bi)
Koc Holding	Industrial	12
Garanti	Financial	12
Arkbank	Financial	11
Turkcell	Telecom	9
Turk Telekom	Telecom	7

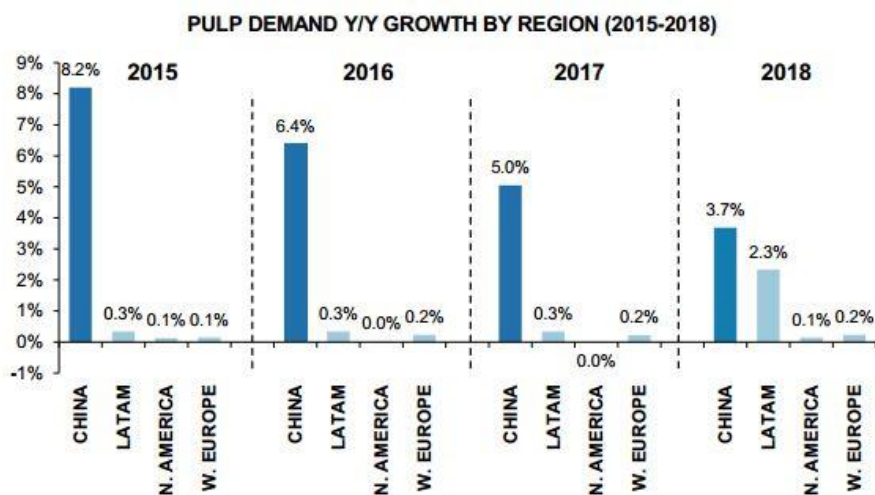
Russia – 5 biggest companies		
Company	Operation	Market Cap (US\$ Bi)
Gasprom	Oil & Gas	59
Rosneft	Oil & Gas	55
Sberbank	Financial	40
Lukoil	Oil & Gas	40
Novatek	Energy	27

China – 5 biggest companies		
Company	Operation	Market Cap (US\$ Bi)
Bank of China	Financial	233
PetroChina	Oil & Gas	202
AliBaba	Internet	188
Tencent	Internet	188
CCB	Financial	157

India – 5 biggest companies		
Company	Operation	Market Cap (US\$ Bi)
Tata Consultancy	Services	73
Reliance	Energy	47
HDFC Bank	Financial	42
Infosys	IT	40
ITC	Consumer Staples	38

Brazil is also unusually diversified and resilient for an emerging market. Unlike most other middle-income countries, it is not a one trick pony. Think of Colombia (too dependent on oil), South Africa (which will live or die depending on the price of a few minerals) not to mention Russia (a gas and petrol station disguised as a country)

Exhibit 10: We Forecast Chinese Pulp Demand Will Grow 4%–8% in 2015e–18e, While Demand in Europe Remains Flat



Source: Hawkins Wright, Morgan Stanley Research estimates

If agribusiness is Brazil's natural strength, the routes to success in Brazil are manifold. In very few other emerging markets, we see companies of the caliber of Itau, Ambev, Totvs and Localiza.

Brazil – Top Exports

1. Oil seed: US\$21.2 billion (11.1% of total exports)
2. Ores, slag, ash: \$16.7 billion (8.7%)
3. Oil: \$13.7 billion (7.2%)
4. Meat: \$13.1 billion (6.8%)
5. Machines, engines, pumps: \$11.4 billion (5.9%)

6. Vehicles: \$9.6 billion (5%)
7. Iron and steel: \$8.9 billion (4.7%)
8. Sugar: \$7.8 billion (4.1%)
9. Food waste, animal fodder: \$6.2 billion (3.2%)
10. Coffee, tea and spices: \$6 billion (3.2%)

Mexico – Top Exports

1. Vehicles: US\$90.4 billion (23.7% of total exports)
2. Electronic equipment: \$81.2 billion (21.3%)
3. Machines, engines, pumps: \$58.9 billion (15.5%)
4. Oil: \$22.8 billion (6.0%)
5. Medical, technical equipment: \$15.2 billion (4.0%)
6. Furniture, lighting, signs: \$9.9 billion (2.6%)
7. Plastics: \$8.3 billion (2.2%)
8. Gems, precious metals, coins: \$7.1 billion (1.9%)
9. Iron or steel products: \$5.7 billion (1.5%)
10. Vegetables: \$5.6 billion (1.5%)

Turkey – Top Exports

1. Vehicles: US\$17.5 billion (12.1% of total exports)
2. Machines, engines, pumps: \$12.3 billion (8.6%)
3. Gems, precious metals: \$11.3 billion (7.8%)
4. Knit or crochet clothing: \$8.9 billion (6.2%)
5. Electronic equipment: \$8.3 billion (5.8%)
6. Iron and steel: \$6.6 billion (4.6%)
7. Clothing (not knit or crochet): \$5.9 billion (4.1%)
8. Iron or steel products: \$5.5 billion (3.8%)
9. Plastics: \$5.4 billion (3.7%)
10. Oil: \$4.5 billion (3.1%)

Russia – Top Exports

1. Oil: \$168.7 billion (50.6% of total exports)
2. Iron and Steel: \$14.9 billion (4.5%)
3. Fertilizers: \$8.6 billion (2.6%)
4. Machines, engines, pumps: US\$8.1 billion (2.4%)
5. Gemas e metais preciosos: US\$7.4 billion (2.2%)
6. Aluminum: \$6.9 billion (2.1%)
7. Wood: \$6.2 billion (1.8%)
8. Cereals: \$5.5 billion (1.7%)
9. Copper: \$4.2 billion (1.2%)
10. Inorganic chemicals: \$3.7 billion (1.1%)

China – Top Exports

1. Electronic equipment: US\$600.3 billion (26.3% of total exports)
2. Machines, engines, pumps: \$364.5 billion (16%)
3. Furniture, lighting, signs: \$98.7 billion (4.3%)
4. Knit or crochet clothing: \$83.8 billion (3.7%)
5. Clothing (not knit or crochet): \$78.5 billion (3.4%)
6. Medical, technical equipment: \$73.8 billion (3.2%)
7. Plastics: \$65.8 billion (2.9%)
8. Vehicles: \$62.7 billion (2.7%)
9. Iron or steel products: \$60.6 billion (2.7%)
10. Footwear: \$53.6 billion (2.3%)

India – Top Exports

1. Gems, precious metals: US\$38.8 billion (14.7% of total exports)
2. Oil: \$30.9 billion (11.7%)
3. Vehicles: \$14.1 billion (5.3%)
4. Machines, engines, pumps: \$13.2 billion (5%)
5. Pharmaceuticals: \$12.5 billion (4.7%)
6. Organic chemicals: \$11.2 billion (4.3%)
7. Clothing (not knit or crochet): \$9.4 billion (3.5%)
8. Electronic equipment: \$7.9 billion (3%)
9. Knit or crochet clothing: \$7.8 billion (2.9%)
10. Cotton: \$7.5 billion (2.8%)

Brazil – Top 5 Wealthiest People		
Name	Operation	Wealth (US\$ Bi)
Jorge Paulo Lemann	Investments	27,8
Joseph Safra	Financial	17,2
Marcel Telles	Investments	13,0
Carlos Sicupira	Investments	11,3
Eduardo Saverin	Internet	6,2
Mexico – Top 5 Wealthiest People		
Name	Operation	Wealth (US\$ Bi)
Carlos Slim	Telecom	74
Ricardo Salinas Pliego	Telecom	17,4
Alberto Baillères	Investments	16,5
Germán Mota-Velasco	Investments	14,2
Jerónimo Arango	Investments	4,0
Turkey – Top 5 Wealthiest People		
Name	Operation	Wealth (US\$ Bi)
Murat Ulker	Food Products	4,4
Husnu Ozyegin	Financial	2,7
Semahat Servim Arsel	Industrial	2,6
Mustafa Rahmi Koc	Industrial	2,5
Ferit Fait Sahenk	Investments	2,5
South Africa – Top 5 Wealthiest People		
Name	Operation	Wealth (US\$ Bi)
Johann Rupert	Financial	7,4
Nicky Oppenheimer	Mining	7,6
Christoffel Wiese	Consumer Staples	6,3
Patrice Motsepe	Mining	2,3
Byaruhanga Kimberly	Mining	2,2
China – Top 5 Wealthiest People		
Name	Operation	Wealth (US\$ Bi)
Wang Jianlin	Real Estate	24,2
Jack Ma	Internet	22,7
Li Hejun	Energy	21,1
Ma Huanteng	Internet	16,1
Robin Li	Internet	15,3
India – Top 5 Wealthiest People		
Name	Operation	Wealth (US\$ Bi)
Mukesh Ambani	Investments	19,3
Dilip Shanghvi	Pharmaceutical	16,7
Azim Premii	IT	15,0
Shiv Nadar	IT	11,1
Cerus Poonawalla	Pharmaceutical	8,5

We can see from the charts above that Brazil ranks high in the sophistication aspect of its economy. Sophistication is not purely related to size. For example; Japan has lost the title of the world's second largest economy to China but is still widely regarded as the world's second most sophisticated economy. There is not a universal definition, but Japan excels in high tech industries, is a powerhouse when it comes to research and development, has robust financial markets, diverse industries, and so on.

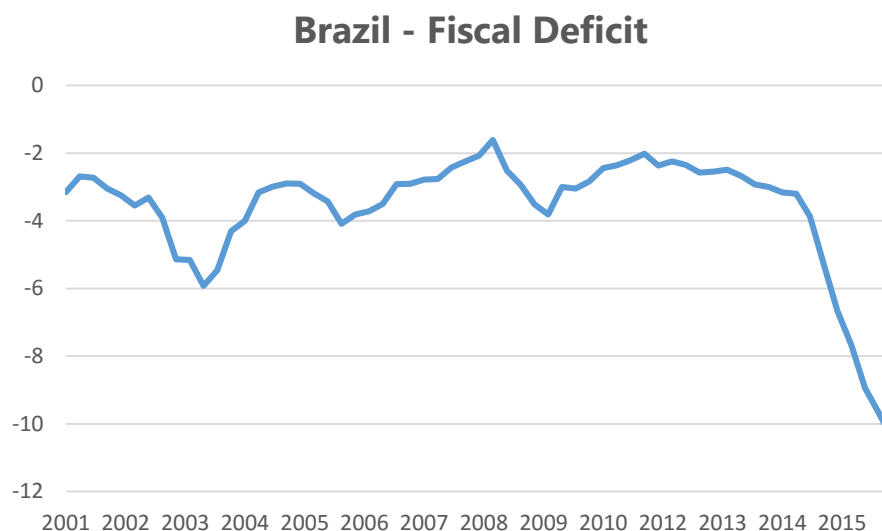
Likewise, one can argue that, possibly with the exception of China, Brazil's economy is the most sophisticated one among emerging markets: it has billionaires that made their fortunes in several different fields like Finance, engineering and commerce. It has a relatively robust financial market and asset management industry.

It has quite a few world class companies (indeed, several studies pointed out the fact that only the medium and small companies in Brazil are badly managed but not the big ones, that are, when adjusted for the country's idiosyncrasies, as efficient as their developed world peers)

Even a cursory glance at the listed stocks in the Bovespa would suggest this is not a trivial emerging market: Brazil has champions in a wider set of industries than most and compensates its lack of integration to global supply chains by having a robust and competitive domestic market. Once again, with the exception of China that is on a class of its own when it comes to emerging markets.

So what will the future hold? If we saw one huge problem back in 2011 (overvaluation of the exchange rate and real estate assets that were disguising a general lack of productivity) we think the next decade will be positive in this regard. On the other hand, a new and cruel problem has emerged thanks to the decade of PT

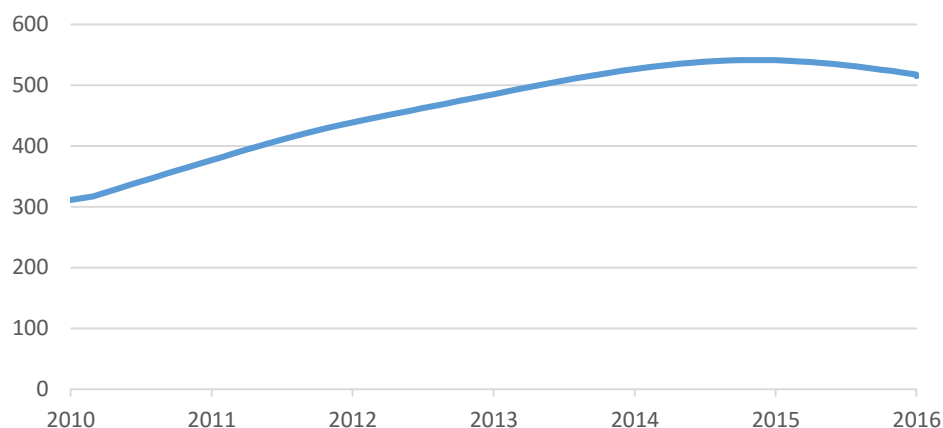
mismanagement: a terrible fiscal deficit that can even imperil the country's solvency.



Between the two “wrong” prices, this house spotted back in 2011 that were trading at ridiculously optimistic prices, the exchange rate and real estate, particularly residential real estate. As we stated, we think the exchange rate is back to justifiable levels, but we still think residential prices, particularly in Rio, have further to fall. Since the system overall still has very little leverage we don't think this will throw the economy back in recession.

Assuming the country avoids another recession in the next few years due to a real estate crash, what is the road ahead for Brazil? This will unfortunately depend a lot on its politicians.

Evolution of Median Real Estate Price in Brazil Thousands of Reais



To paraphrase one famous commentary done by a European bureaucrat at the eve of the euro crisis, "we all know what should be done, we just don't know how to do it and remain elected afterwards" The fact is, Brazilians, sadly, love the state. They dream of being employed by it, they hope their sons and daughters know people who control it; they even think it normal to take advantage of it.

Meanwhile, reforms like labor reform (in a country where employing anyone is really an act of imprudence), pensions reform¹ (if we could choose only one that would be it. Brazil manages to spend more on pensions than much older countries) and tax reform remain on paper. No wonder... as is always the case in Brazil insiders are powerful and protect fiercely their stakes.

The result: Brazil is, to put it mildly, a nightmarish country to do business with, and bad countries to do business with have a very strong tendency to be poor countries

¹ [Link: World Bank – Pension Expending 4Q2013](#)

Country Comparison	
Ease of Doing Business Ranking	GDP per Capita
1 - Singapore	82763
2 - New Zeland	53931
3 - Denmark	45537
4 - South Korea	27970
5 - Hong Kong	55084
38 - Mexico	17315
55 - Turkey	19788
73 - South Africa	13049
90 - China	13206
120 - Brasil	15893
130 - India	5701

For the first time in many years, we are beginning to feel optimistic about Brazil. The administration that is on the verge of taking over the country is at least saying the right things. This fact alone is a huge change. For the past 10 years, all the partners of this house could do was to pick up the daily newspaper with dread certain that from their government only bad news and worsening could come.

If, at least, a pensions reform is enacted, even if it doesn't solve the country's fiscal mess right away, it would, in our opinion, be a huge signal. As creditors of the Brazilian government ourselves via the fixed income products in our fund, this house would easily prefer that the long-term solvency of the country is assured. That is a much more important fact than a discussion if next year or the year after the next will have half a percentage point of GDP more or less of deficit spending.

To recur once again to one of our favorite investing phrases, in investing, what is comfortable seldom is very lucrative. Brazil will, for the remaining of our lives, be a middle-income country, with high taxes, asphyxiating bureaucracy, a population that lacks proper

education and work ethic, endemic corruption, statist policies and a terrible business environment.

At the same time, like very few emerging markets, it will hopefully remain a vibrant democracy, with a young and creative population that excels in business areas as varied as advertisement, aircraft engineering and meat processing. For an unborn child deciding which BRIC to be born in, Brazil would probably be a wise choice: not autocratic like Russia or China, not as poor and chaotic as India.

Over time, if it does a few things right, it should converge a bit more towards us levels of GDP per capita, reaching, we would guess, around 35%-40% in PPP terms around 2030.

Regardless, due to its very size, it will keep making fortunes for its boldest entrepreneurs and investors. Some of them, understandably, we would say, will give the country a complete pass, tired of so many and so well-known problems. That would be the most comfortable path for sure. Maybe not the wisest nor the most lucrative one.

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