

Brazil Outlook 2006

The South America largest economy



INVESTIMENTOS

FOCAL POINTS:

GDP Growth
Fixed Income
Equities
Interest Rate
Currency
Debt Rating X
Brazil Risk
Trade Balance
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Sectors

▷ GROSS DOMESTIC PRODUCT – GDP

We expect a GDP growth to expand up to 4% in 2006 after a weak GDP growth near to 2,6% last year. The main challenge for the currently government in Brazil will be to pursue growth in the economy while maintaining inflation in check.

Falling inflation and increasing confidence will create the conditions for stronger GDP growth in 2006-07. All signs indicate that the economy this year will have a better performance compared to last year.

The CB revised its 2005 GDP growth expectations to 2.6%, down from 3.4% in 3Q05 inflation report. For 2006, GDP growth expectation remained at 4%;

▷ FIXED INCOME PERFORMANCE

Brazil's benchmark Global 40 due October 2040 climbed to a record high, quoted by around 131,15 percent of their face value.

With interest rates declining in Brazil, there is a real possibility of domestic investors switching funds from fixed income to equities. We maintain our view that, despite overall sentiment that pension funds would be the main source of this flow, we see that it is in the mutual fund industry where there is a large space for equity funds to gain importance.

Emerging markets closed-end funds appear to be the flavor of the year, sporting some of the best returns in 2005.

▷ STOCK MARKET PERFORMANCE

Big year in Brazil, thanks to Bovespa and Novo Mercado. Most of the new listings have taken place on the Novo Mercado (New Market), a segment of the Bovespa launched in 2001 to address concerns over low standards of corporate governance. Companies listing on the Novo Mercado may issue only voting shares.

We are still maintaining our **bullish** view for the year ahead. The Brazilian Stock index have been hitting record highs lately, as foreign investors appear to be reducing exposure to dollar-based assets by shifting

money into higher-growth assets from developing countries, where local currencies have been appreciating against the dollar.

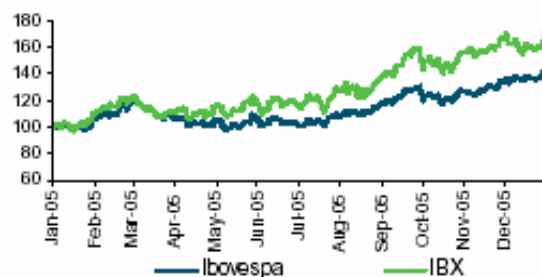
The São Paulo Stock Exchange reported foreign-investment flows have been rising in recent months and recently hit their highest level ever. The Brazilian index is finished 2005 by around 33.455 points, leaving it around 29% stronger compared to 2004 representing the highest level over the past 5 years.

The trend is widely expected to continue next year as we forecast till 41.000 points of average year-end, implying an about 18% upside potential from current levels in nominal terms. Mining, Steel, Banking, Consumer and Power sector stocks were among the biggest climbers of the year.

	Points	Day	In R\$ (%)		12M
			MTD	YTD	
Ibovespa	35,475	1.54	6.04	6.04	45.59
IBX 50	5,190	2.02	7.60	7.60	57.17
IBX	11,479	1.97	7.21	7.21	55.29
IGC	3,894	1.23	6.42	6.42	60.43

	Points	Day	In US\$ (%)		12M
			MTD	YTD	
Ibovespa	15,141	1.13	5.89	5.89	82.68
Dow Jones	10,959	0.71	2.26	2.26	3.17
Nasdaq	2,306	1.26	4.55	4.55	10.32
S&P 500	1,285	0.94	2.98	2.98	8.21
Mexico	1,775	1.13	5.74	5.74	59.53
Merval	529	0.77	3.54	3.54	19.17
Chile	2,071	0.71	3.76	3.76	29.06

Performance Ibovespa, IBX





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▷ INTEREST RATE

Some analysts would be working with January IPCA expectation of 0.6%. The actual number will only be released in the beginning of February but the IPCA-15 to be out on January 27th will be an efficient preview.

We maintain our expectation of a 75 bps interest rates cut on the 18th which, considering there will be less COPOM meetings in 2006, would mean the recent pace of interest rates cut would be maintained.

We maintain our expectation the Selic rate average of 15% in 2006, which represent a total cuts of 300 bps from current levels.

▷ CURRENCY

Brazil's currency has appreciating due increased inflows from overseas bond sales will outpace dollar purchases by the central bank. It has been seven years since such low levels of risk in Brazil currently. Stands at its lowest levels at 286 bps, that has led companies to sell bonds abroad.

The Central Bank will likely continue to intervene to build reserves.

We continue to believe the most likely scenario is a gradual depreciation of the Real ending 2006 at around R\$2.40/US\$. In this case, the strategy continues to be being more exposed to sectors more dependent on the domestic economy.

▷ DEBT RATING X BRAZIL RISK

Brazil's net public sector debt is expected to decline by the end of 2006.

Its also worth highlighting Brazil's country risk, which dropped to 280 basis points, its lowest level ever. As we mentioned, the country risk at such low levels is likely to positively impact equity prices.

The continuation of the Brazil risk downward trend is one of the main reasons we believe Brazil's equity market deserves to be re-rated.

We believe that ratings upgrades are possible in Brazil over the course of 2006 and becoming "investment grade" in 2007.

The overweight recommendation in external debt markets remains Brazil, which continues to be the bellwether for investor sentiment toward emerging markets.

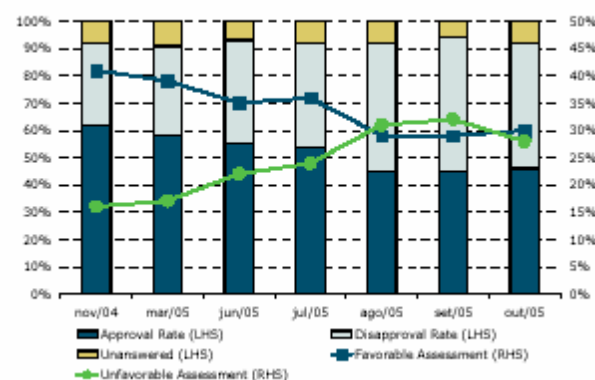
▷ TRADE BALANCE

Industrial production is seen expanding last year as strong export activity generates a trade surplus of USD 42 billion. For 2006, industrial output should expand another USD 35 billion on the year.

An export boom is widening Brazil's surplus thanks to a competitive currency, structural changes in the economy and strong prices for key commodities like iron ore, sugar and steel.

▷ ELECTIONS FIGURES 265 days to go

Pres. Lula's Popularity Figures



Source: Ibope

"Fighting corruption and building infrastructure for an expanding economy are among the priorities Brazilian President Luiz Inacio Lula da Silva has set for next year"



▷ SECTOR RECOMMENDATIONS - BUY

On our view, we looked at the multiple-to-growth relationship and remaining overweight to banks, consumers, electric utilities, infrastructure and mining;

Reinforcing our conviction: We are revising our iron ore price increase estimate for 2006 from 20% to 25%.

Dilma Rousseff, the government's chief of staff, announced the date for the auctions of the 2nd Phase of the Federal Toll-roads concession program – April 15th. In the previous statements the government had already signaled that the auctions should take place until April.

This is good news for the sectors since it reinforces the potential upside for the stocks this year and should positively impact its shares.

As we mentioned soon after the December “new energy” auction, the government's intention to implement a second auction as soon as in May is positive.

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