

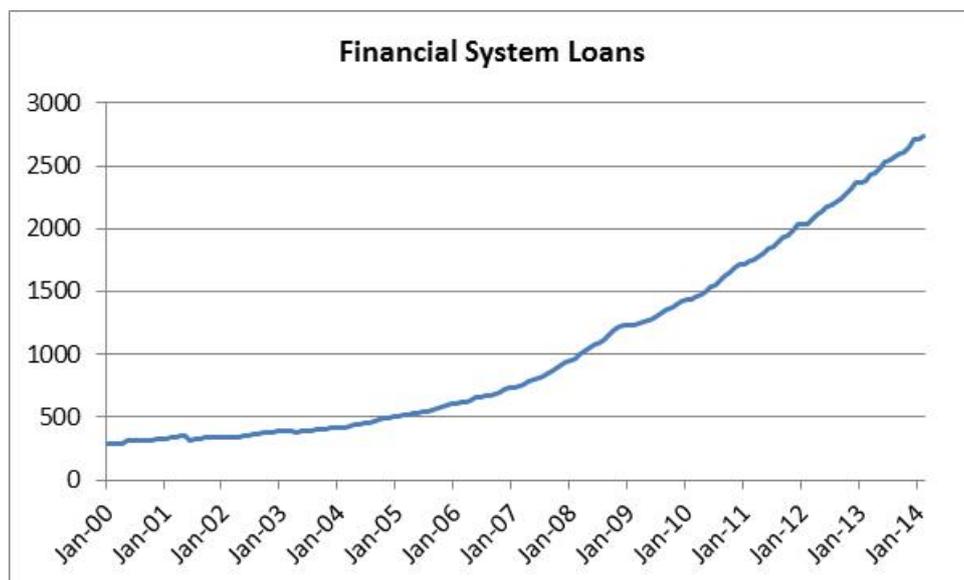
THE PROBLEM WITH BRAZILIAN BANKS



Russell Clark's
Market Views

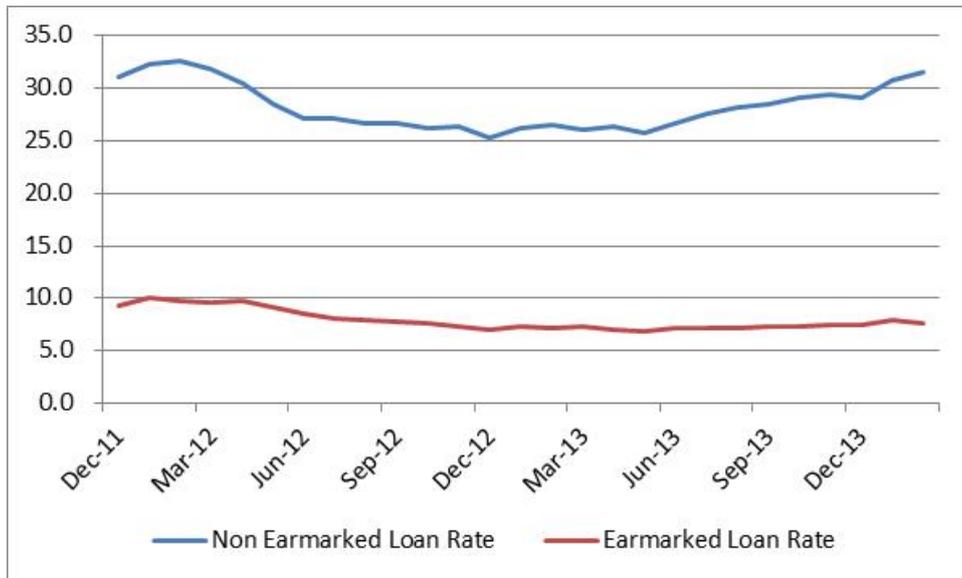
“The Brazilian Government chooses to fund its banks at below market rates. Unless there is a change of policy, it seems likely that Brazil is heading for some sort of financial crisis.”

Superficially, Brazil seems like a banking Nirvana. Loan growth has been strong, with barely a dip during the financial crisis.

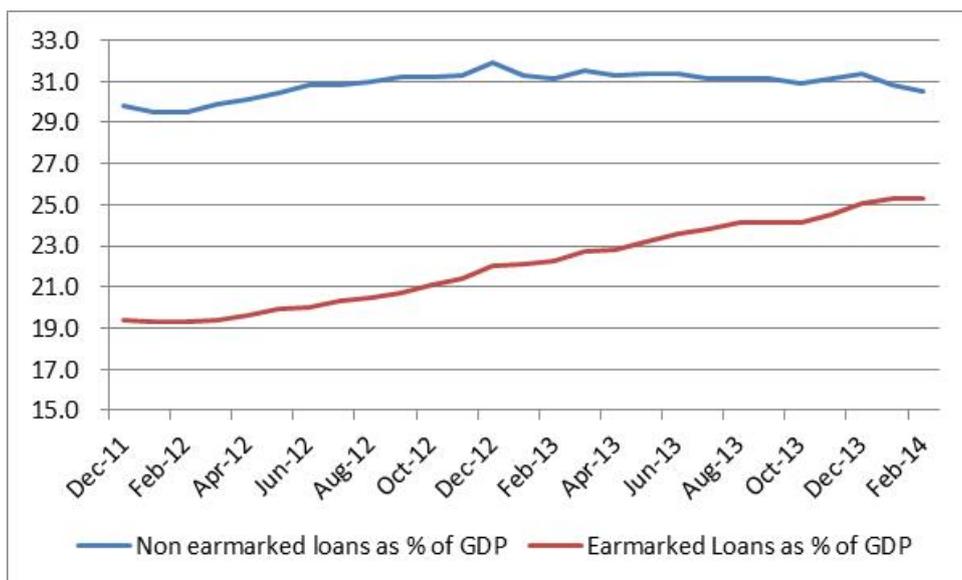


Brazil also has a very good Central Bank that releases detailed information on its economy. One of the most interesting features of the financial system is the very high interest rates that banks charge both corporates and households. Recent data shows that corporates are charged on average 23%, while households are charged 41%. With the key central bank rate at 10.25%, the central bank also reports that banks earn an average interest rate spread of nearly 20%. If you had not looked at the Brazilian financial system before then, you may be shocked by such numbers, but high interest rates and spreads have been an enduring feature of the Brazilian financial sector.

Recently however, the Brazilian Central Bank has begun to report lending rates of government-directed loans separately from those of purely private sector, called “earmarked loans”, as can be seen below government directed lending is at interest rates significantly below market rates.



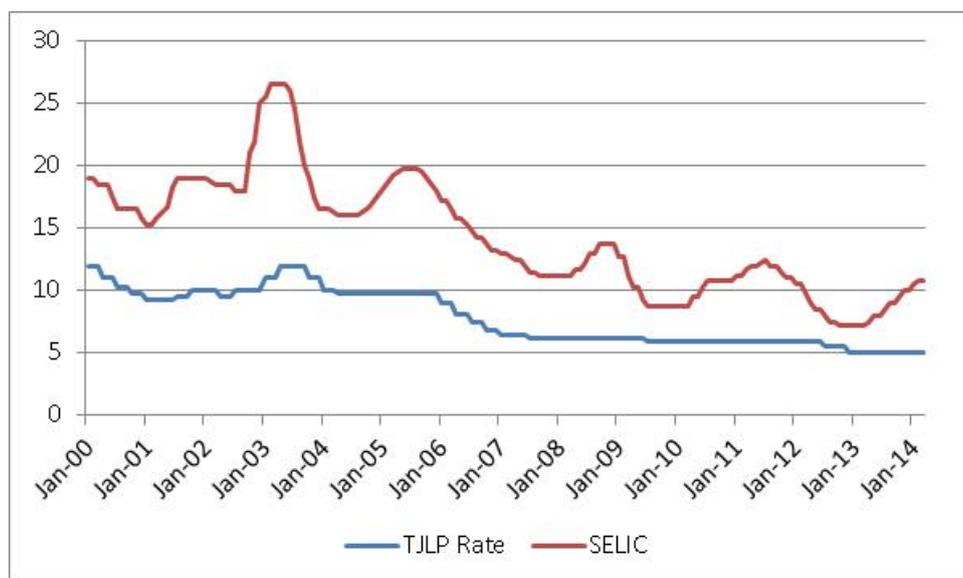
Such a huge spread between interest rates has led to a very predictable growth in earmarked loans versus non-earmarked loans.



Central Bank data shows that earmarked loans are becoming a much more important part of the financial system. Given the increasing dominance of earmarked loans in the Brazilian economy, they deserve more attention in my view. According to the Brazilian Central Bank, BNDES supplies about 73% of earmarked credit to the corporate sector, while 61% of earmarked credit to households are for real estate financing, and typically involves Caixa as a conduit. BNDES and Caixa are two wholly government owned banks. Readers of the financial press should find this intriguing, as Moodys has recently downgraded both banks (https://www.moodys.com/research/Moodys-downgrades-BNDESS-and-Caixas-senior-ratings-to-Baa2-lowers--PR_268321).

BNDES recently issued an international bond in January 2014, which despite the downgrade is trading very well. Fortunately the prospectus attached to this bond issuance provides a treasure trove of financial information. Perhaps most intriguing for me was that BNDES Brazilian Real funding has been stable for the last few years at 6.5%. The majority of BNDES Brazilian Real funding comes from two sources, one is FAT funds, and the other is the National Treasury. According to the prospectus, interest on FAT funds and from the National treasury are payable at the TJLP rate. The TJLP rate is available on Bloomberg and is presented below. The Benchmark SELIC rate is also presented for

comparison. I would point out that with the SELIC rate is the borrowing rate for the treasury, who then chose to lend to BNDES at 6.5%.

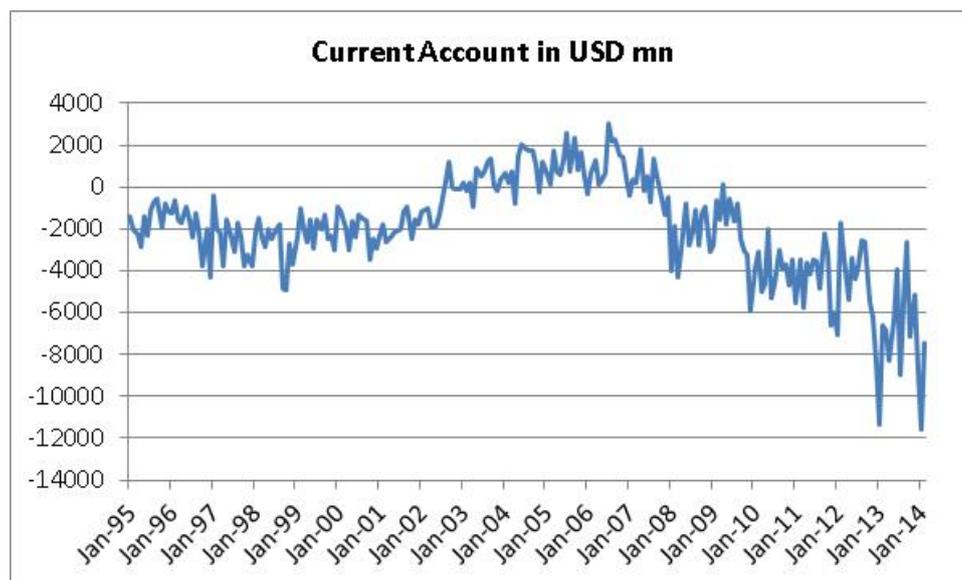


The TJLP rate is set by the Central Bank and is based on two components, the targeted inflation for the next 12 months, and a risk premium which incorporates a country risk premium over the medium to long term. For reference the Central Bank inflation target has been 4.5% since 2005.



Brazilians tend to base their inflation expectations on strength or weakness of the currency.

The problem is that the Brazilian Real is very expensive. This can be most notably seen in its current account balance.



The problem for the Central Bank is that by putting up interest rates it reduces demand for non-earmarked loans, pushing more loan demand into earmarked loans, making the economy less responsive to rising interest rates. According to February 2014 data, total financial system credit was growing at 14.7%, with non-earmarked loans growing at 7.4%, and earmarked loans growing at 24.9% on an annual basis. Raising the Selic rate has less and less effect on the economy, forcing yet more lending into the hands of the government banks. To control lending in the government banks the central bank would need to raise the TJLF funding rate, which would require them to abandon their inflation target, which would likely cause the Brazilian Real to fall. The bigger issue here is that the Brazilian financial system is now heavily short the USD dollar as we can see from the Bank of International Settlement data.



To my mind the Brazilian Central Bank faces a dilemma. To protect its inflation target and credibility the Central Bank is raising rates aggressively. The more it raises rates the more lending that is being passed through loans at a small premium to its inflation target. The more lending conducted by government owned banks, the less relevant the SELIC rate becomes.

Furthermore, the Real seems overvalued when we look at the current account, but high domestic interest rates have forced ever more overseas borrowing. The more the central bank raises rates, the less control it has over the economy. Conversely if Brazil cut rates it seems likely that Real would devalue and the short USD position of the financial system would likely cause a financial crisis.

The key driver here is that the Brazilian Government chooses to fund its banks at below market rates. Unless there is a change of policy, it seems likely that Brazil is heading for some sort of financial crisis.

INFORMATION

Issue Date:	April 2014
Source:	Bloomberg, unless otherwise stated
Investor Relations:	Samantha Dunn
Email:	info@russellclarkim.com
Telephone:	+44 (0)20 7838 7580
Website:	www.russellclarkim.com

Business and registered address: Russell Clark Investment Management Limited, 9 Chester Close, London SW1X 7BE, United Kingdom. Registered in England and Wales - Company number: 04034280

DISCLAIMER

This Market View has been prepared and issued by Russell Clark Investment Management Ltd (the "Firm") authorised and regulated by the Financial Conduct Authority. It has been approved as a financial promotion by the Firm and as such is intended **for professional clients and eligible counterparties only and is not intended for retail client use**. It is not intended for distribution to any country where such distribution or use would be contrary to local law or regulation.

This Market View is provided for information purposes only and should not be regarded as an offer to buy or sell any investments or related services that may be referenced herein. No guarantee is made as to the accuracy of the information provided which has been obtained from sources believed to be reliable. The view expressed in this Market View are the views of the portfolio manager at time of publication and may change over time. Nothing in this Market View constitutes investment, legal tax or other advice nor is it to be relied upon in making an investment decision. No recommendation is made positive or otherwise regarding individual securities mentioned herein. Past performance is not indicative of future performance. The price of investments can go up as well as down and can be affected by changes in the rates of exchange. The information contained in this document is strictly confidential and is intended only for the use of the person who has been provided the Market View by the Firm. No part of this Market View may be divulged to any person, distributed, resold and or reproduced without the prior written permission of the Firm.

Where "forward looking" information, including estimates, projections and subjective analysis and judgement are provided no representation as to the accuracy of such projections or estimates or that they may be realised. Certain assumptions used in formulating such "forward looking" information may differ materially from actual events or conditions.