

Brazil's Real, Bonds Rally as Investors Bet on Lula's Reforms

By Elzio Barreto (Bloomberg)

Rio de Janeiro, April 17 (Bloomberg) -- Brazil's currency surged and the benchmark bond jumped to its highest price in six years, as investors bet President Luiz Inacio Lula da Silva will push through legislation aimed at spurring economic growth and reducing the risk of default.

Lula, a former metals worker who took office Jan. 1, has moved to allay investors' concerns that the government may be unable to keep up payments on USD 300 billion of debt. This week he won support from state governors and union leaders for bills to cut pension spending and streamline the tax system to lift exports. The real (BRR), which fell by a third in 2002, is the best performing currency this year among 59 tracked by Bloomberg, with a gain of 17%.

"They've moved ahead with one doable step at a time and did it in a very careful, deliberate and orchestrated way," said Robert Kowitz, senior portfolio manager at Federated Investors Inc. who helps manage USD 1.9 billion of international fixed income securities including Brazilian bonds.

The currency rose 2% to BRR 3.0325 per USD, the strongest level in almost eight months, locking in the biggest weekly gain since the week ending Dec. 20, when Lula named a former FleetBoston Financial Corp. banker to run the nation's central bank. The 8% bond due 2014 climbed to 86 cents on the USD, cutting the yield to 11.5%, less than half the level in September, just before Lula was elected president. The bond last traded at that price in October 1997, when the government announced the sale of the state telephone monopoly to private investors.

Bonds Gain

Brazil's bonds along with other emerging market debt are gaining in part on a rise in investment flows from pension funds seeking higher returns than what bonds in the U.S. or Europe offer. Brazil's benchmark bond yields about 8.7 percentage points more than U.S. Treasuries with a similar maturity.

Brazil's 27 governors yesterday backed Lula's proposals to raise the minimum retirement age for civil servants and limit pension benefits. They also supported plans to combine separate state taxes on goods and services into a single value added tax. "This is important as his administration establishes needed credibility with creditors and investors, both domestic and foreign," said Andrew Cummins, chief investment officer at Explorador Capital Management in San Francisco, which manages about USD 30 million in mostly Latin American equities including Brazilian shares. "More work remains to be accomplished, but it's an important indication of the probable future outcome of Lula's reform plans."

ABN Amro Investment

ABN Amro Holding NV, the biggest Dutch bank, also said yesterday that it plans to buy the Brazilian unit of Italy's Banca Intesa SpA for BRR 2.29 billion (USD 741.5 million) in cash and stock, while many of its larger international rivals scale back operations in Brazil.

Fabio Barbosa, chief executive of ABN Amro's Brazil unit, said the purchase reflects the bank's confidence in Lula's ability to spur growth and ensure the government keeps paying its debts. "It's a sign of commitment to Brazil by a big international bank, which is very significant," said Joao Medeiros, director of currency brokerage Pioneer in Sao Paulo. "What we're seeing now from some international investors is much different than what was happening in the past."

Brazil's central bank President Henrique Meirelles, in New York this week to meet with bankers and investors, said in an interview that the central bank wasn't concerned about the currency's gains and would let the exchange rate be set by the market.

Inflation

The rising real may reduce inflation and lead the central bank to cut in benchmark interest rates, now at four-year highs, as early as next month, said Nick Field, who managed USD 400 million of emerging market debt at WestLB Asset Management Ltd. in London.

“Now investors are perceiving that the substantial monetary tightening of the previous months is easing the inflationary pressures and pushing up the real,” he said. “Rates may be coming down soon.”

The central bank has lifted the overnight target rate four times since October to 26.5 percent.