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MARKET VECTORS™

The Investment Case for Brazil Small-Caps

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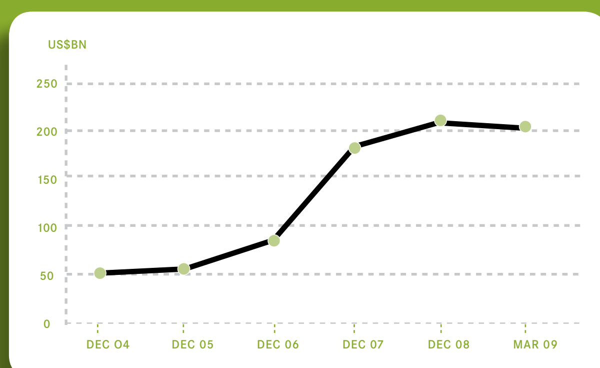
Brazil,

the largest country and economy in South America, is the world's fifth-most populous nation and its tenth largest economy. Brazil shares borders with every other South American nation except for Chile and Ecuador.

Examining the Macro Picture

Characterized by well-developed agriculture, mining, manufacturing and service sectors, Brazil's economy has expanded its presence as a world market. While hard hit by the current global economic crisis that began to unfold in 2007, Brazil's economy has seen dramatic improvement in stability during recent years on the back of domestic demand and a more active export policy. Sound macroeconomic policies have bolstered international reserves to historically high levels [**FIGURE 1**], reduced public debt and allowed a significant decline in real interest rates.

Figure 1 International Reserves (US$ Billion)



Source: 5

Small-Caps: A Better Way to Capture Brazil's Secular Trends?

A PLAY ON DOMESTIC INVESTMENT THEMES—
While Brazil's large-cap companies are more dependent on the global industrial cycle and other external factors such as oil prices and commodity demand from China, the nation's small-caps are more dependent on real growth in the domestic economy.

RISING DOMESTIC CONSUMPTION—
Rising domestic incomes are creating a growing middle class that is becoming increasingly consumer-oriented. This trend is likely to favor Brazil's small-cap sector since many of these companies are in the consumer staples, consumer discretionary, health care and other sectors that directly or tangentially serve domestic consumers.

YOUNG AND GROWING POPULATION—
An increasing, modernizing population bodes well for the domestic economy, as Brazilians come to need cars, houses, furniture, cell phones and computers.

SMALL-COMPANY FUNDAMENTALS—
We believe that those Brazilian small-caps with less debt and stronger balance sheets than their large counterparts are well positioned for recovery once the global economy improves. Small-caps worldwide have historically underperformed large-caps during bear markets, but have tended to lead the way out of downturns.

ATTRACTIVELY PRICED—
Accounting for over half of the nation's IPOs in 2006 and 2007, Brazil's smallest stocks fell swiftly during the height of the global crisis and almost all newly-listed companies fell below their offer price.[1] These depressed prices may represent excellent value for opportunistic investors who believe in Brazil's long-term growth prospects.

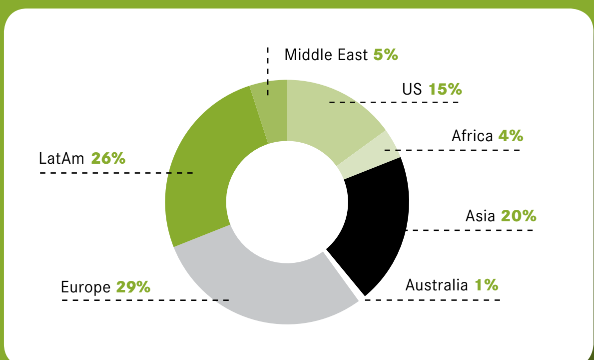
Industry	Drivers/Supporting Factors[2]
Consumer Goods	Domestic Demand
Industrials	Infrastructure Investments
Banking	Well Capitalized/Low Leverage
Agribusiness	Local Consumption/Demand from China/ Increased Profitability for Farmers Selling Abroad (decreased value of real)
Real Estate	Pent up Demand/Improved Affordability/Available Financing

Figure 2 Select Macroeconomic Forecasts

	2008	2009F	2010F	2011F	2012F
Real GDP growth (%)	5.1	-1.3	2.2	3.0	3.4
vs. US GDP growth (%)	1.1	-2.8	0.0	3.5	3.6
Domestic demand (%)	8.1(F)	2.0	3.5	3.7	6.8
Unemployment (%)	7.9	9.2	9.8	9.9	9.3
Foreign reserves ($ bil.)	207.0	159.0	152.0	176.0	187.0
Trade balance ($ bil.)	24.8	10.3	27.5	42.7	21.1
Foreign direct investments ($ bil.)	45.1	26.0	32.0	38.0	49.0

Source: 6

Figure 3 Diversified Export Profile, Exports by Destination



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In the Driver's Seat This Time Around

During past economic crises, Brazil was severely impacted by its high debt levels. In the recent past, however, the administration under President Luiz Inacio Lula da Silva paid down Brazil's debt and placed tough regulations across many industries such as energy and finance. The result? While other emerging nations were funding growth by leveraging assets and creating massive debt, Brazil maintained a steady, stable growth rate of about 4.5% during recent boom years (2004-2007). Over the last ten years ending December 2008, Brazil was the slowest-growing BRIC nation with average annual real GDP growth of 3.3%.

Although most developing nations currently face significant challenges, Brazil may emerge from the global downturn in a stronger position than many of its counterparts. Why? **Trade represents a small part of Brazil's GDP, exports are diversified geographically** **[FIGURE 3]**, there is **low dependence on external financing** and **reserve accumulation** over the past several years has provided an important buffer to external shocks.[3,4] In fact, Brazil's international reserves currently cover the country's sovereign and private external debt obligations. Importantly, Brazil's economy is **relatively insulated from changes in energy prices** due to its energy exports and domestic hydroelectric energy sources.

What's more, Brazil's banking system was not highly leveraged leading up to the current global financial crisis. This, along with the other strengths noted above, have allowed benchmark interest rates to decline from 26.5% in 2002 to 11.25% currently. While interest rates have come down sharply, they are still relatively higher than U.S. rates and have the ability to go even lower over the longer term. Brazil's credit spreads have also proved less sensitive to global turmoil than those of its peers.

Long perspective

Brazil small-cap stocks hold the potential to generate attractive relative returns for investors who are willing to accept high levels of volatility and the risk of significant capital loss. There are myriad factors supporting future growth in Brazil, but there are also characteristics of this market that warrant a cautious view. Slowing exports, political upheaval (the current administration will complete its maximum allowable term in October 2010), and the need for deeper fiscal reform may present significant hurdles to continued growth. Signficant risks are also presented by the recent global investment crisis, which may derail domestic growth in this emerging economy. Small-cap equities are typically more volatile than larger-cap stocks.

Figure 4 Brazil GDP—Composition by Sector

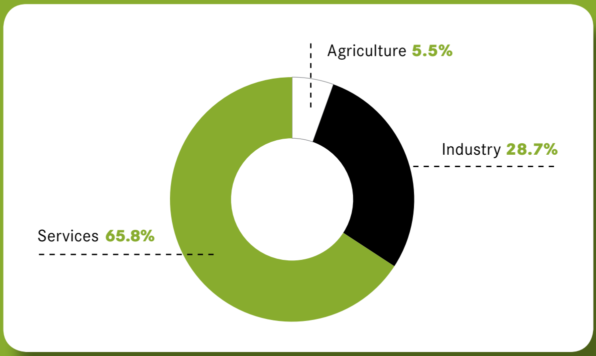

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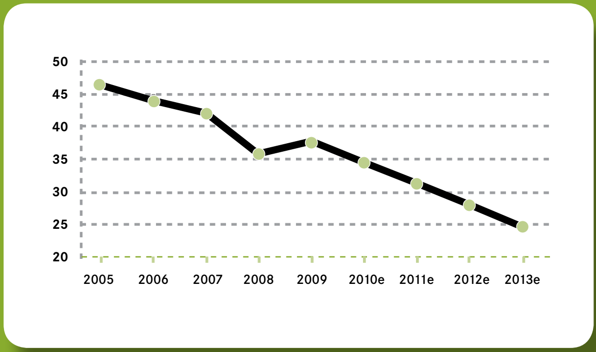
Figure 5 Public Sector Net Debt (% of GDP)



Source: 9

References

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