Brazil's Comeback

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November 2016

Rio de Janeiro

São Paulo

Brazil is near the end of its worst recession on record. Latin America's largest economy has turned the corner and is, once again, presenting itself as an attractive investment opportunity. After several years of political turmoil, economic challenges and a soaring fiscal deficit, investors lost confidence in the nation's prospects. In 2015, Brazil's economy contracted by 3.8%, its worst annual contraction since 1990,[1] and the country's credit rating was downgraded to below investment grade. We believe there is now clear evidence to suggest that a recovery in Brazil is currently underway, creating an attractive entry opportunity in a deep and broad equity market.

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[1]World Bank

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Changing of the Guard

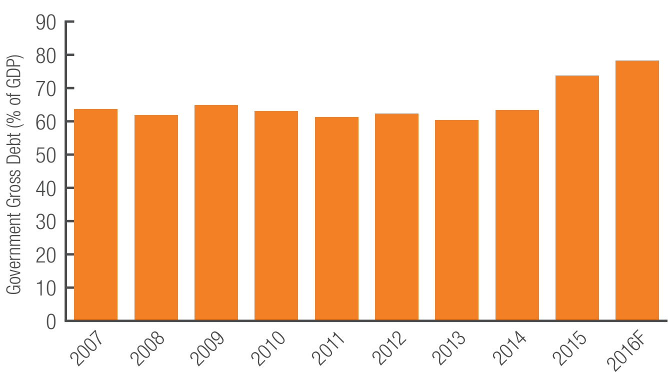
Up until mid-2016, the left-wing Workers' Party (PT) governed Brazil for 13 consecutive years. The PT came into power with Luiz Inácio Lula da Silva (Lula) in 2003. During his presidency, Brazil's economy prospered, fueled by rising commodities demand from China. Lula took advantage of the fortuitous prosperity to please his voter base with subsidized housing and education, tax breaks to labor intensive industries, and other costly programs aimed at lifting Brazilians into the middle class. By the time Dilma Rousseff became president, demand for commodities had declined but Brazil was still spending at elevated rates. On August 31, 2016, Ms. Rousseff was impeached and removed from office for manipulating the budget. Hours later, acting president and former vice president, Michel Temer of the Brazilian Democratic Movement Party, was sworn in as the new president of Brazil. He will serve out the remainder of the term, which ends in 2018.

Promising Reforms

President Temer has promised to revive Brazil's economy by focusing on policies that will encourage stronger and more sustainable growth. He intends to reduce the country's fiscal deficit, reform social security, and create a more business-friendly environment. With an experienced economic team and a large government coalition, investors are optimistic that many of President Temer's reforms will succeed.

One of President Temer's first priorities is to stabilize the country's growing debt burden. For 2016, the government's gross debt is projected to rise to 78% of GDP, up from 63% in 2014 (chart 1).

Chart 1: Brazil's Fast-Growing Government Debt



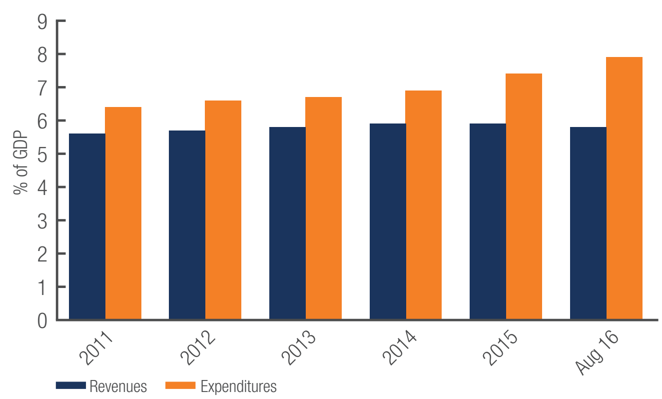
Source: IMF Fiscal Monitor, October 2016.
F=Forecast. Forecasted numbers are projections and not guarantees.
Past Performance Does Not Guarantee Future Results.

President Temer intends to rein in the country's debt by implementing austerity measures. In June 2016, he proposed a constitutional amendment to cap government spending. The proposal would freeze current government expenditures to the country's inflation rate for 20 years.[2] In early October, the proposal was approved by Brazil's lower house of Congress and is in motion towards a final vote in the Senate. This is an important triumph for President Temer and is a signal of his willingness and ability to implement crucial changes.

Another important, and necessary, item on President Temer's budget reform is the country's social security system. Brazil's existing social security system, which has no minimum retirement age, is one of the most generous in the world and represents more than a quarter of the country's overall spending.[3] Social security expenditures have been steadily growing while revenues remain fairly flat (chart 2).

The Brazilian government is currently studying various options to manage the pension imbalance and this is an essential part of stabilizing the government deficit.

Chart 2: Brazil's Social Security Expenditures Outpace Revenues



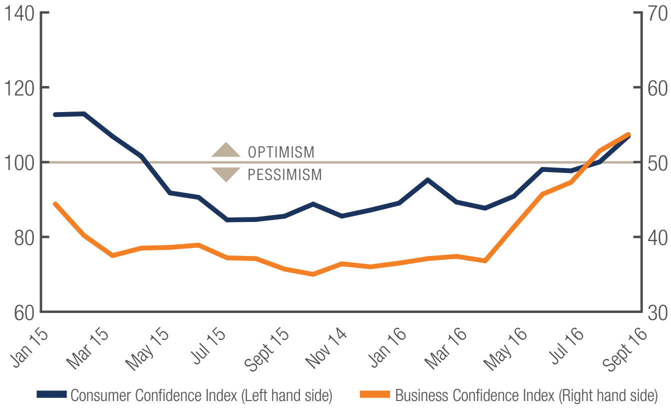
Source: Banco Central Do Brasil. Based on 12-month accumulated flows.

[2]FT
[3]Reuters

Improving Confidence

With a new government in place and steps towards fiscal reform, consumer and business confidence appear to have returned to Brazil. Over the past few months, the consumer and business confidence indices, a gauge of expectations, have trended upwards, an indication that both consumers and companies have a more positive outlook on the economy (chart 3).

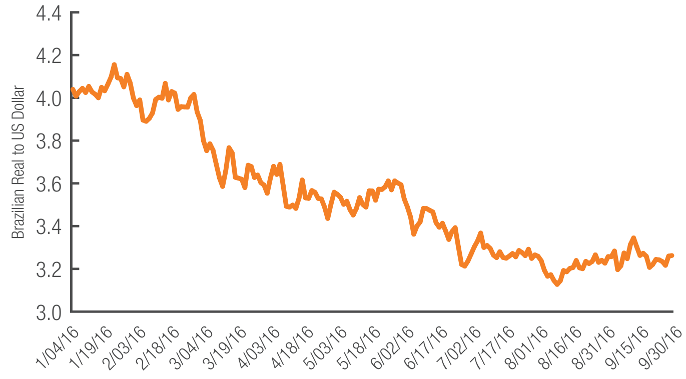
Chart 3: Consumer and Business Confidence are Rising



Source: Banco Central Do Brasil. Consumer Confidence Index varies between 0 (absolute pessimism) and 200 (absolute optimism). Business Confidence Index varies from 0 to 100. Any level above 50 indicates confidence.

The enthusiasm over reforms and a rebound in global commodity prices have also been beneficial for the Brazilian real. Since the beginning of 2016, the real has continued to strengthen against the US dollar, from a record low of R$4.16 to the dollar in January to R$3.26 to the dollar by the end of September (chart 4). According to Bloomberg, the real is the world's best performing currency in 2016.

Chart 4: The Brazilian Real Strengthens Against the US Dollar



Source: Bloomberg.

Investing in Brazil's Potential

In Brazil's current economic environment, companies that have sound fundamentals are likely to benefit. At Mirae Asset, we invest in Brazilian companies that have strong management teams and structural growth stories such as Lojas Americanas and Raia Drogasil. Lojas Americanas is a traditional retail chain with more than a thousand stores in major cities in Brazil and has been in business for 87 years. The company's multi-channel structure has allowed them to reach customers through a wide range of products and services.[4] Raia Drogasil is Brazil's largest drugstore chain by revenue and number of stores. The company has demonstrated a strong ability to consistently increase revenues while expanding its store count.[5] Both companies stand to benefit from Brazil's reforms. Not only will they benefit from a stronger consumer, but also from expected lower interest rates, which will reduce interest expenses on their balance sheets and facilitate improved returns from forthcoming store openings across the country.

President Temer's business-friendly agenda and reform policies have brought investor confidence back to Brazil, which has stabilized the currency, led to a reduction in inflation rates, and allowed the central bank to cut the base rate. These trends should help stimulate growth. Brazil's positive reforms are likely to continue for many years, and while this may lead to periods of uncertainty in its equity market, it could also present new and exciting investment opportunities. As an emerging markets expert and active manager, Mirae Asset has a deep understanding of Brazil's economy and can help investors identify investment opportunities that have the potential to outperform in the long-term.

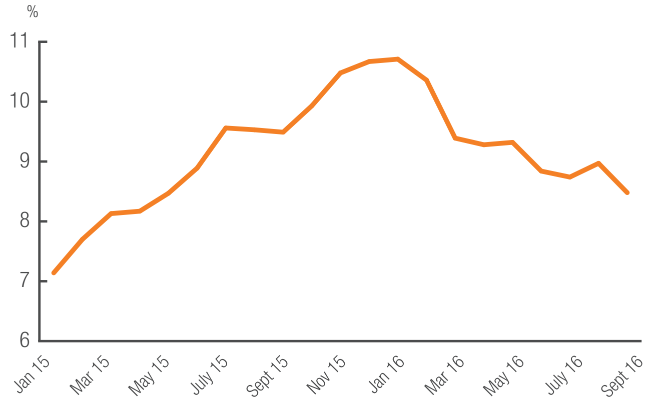
[4]Loja Americanas Investor Relations.
[5]Raia Drogasil Investor Relations.
Mirae Asset Global Investments may or may not hold positions in the companies discussed and this is not a recommendation to buy, hold or sell these companies.

A stronger, stable real and an uptick in sentiment have led to an improvement in inflation expectations and potential interest rate cuts. Brazil's annual inflation rate has declined from a high of 10.7% in the beginning of 2016 to 8.48% by September 2016 (chart 5). Although this is still much higher than the country's official target of 4.5%, investors expect inflation to continue to decline. In October 2016, the Brazilian central bank cut the benchmark rate, known as the Selic, by 25 basis points (the first cut in four years). As inflation slows, the Brazilian central bank has signaled that further interest rate cuts in the near future are possible which would reduce borrowing costs for businesses and consumers and drive investment and growth across the country.

The International Monetary Fund's (IMF) GDP growth projections also suggest that Brazil's economy may have bottomed and that a rebound is likely. GDP growth is expected to continue to contract, albeit more slowly, in 2016 but a recovery, returning to positive growth, is projected for 2017 (chart 6). At 3.8%, this is one of the biggest swings from current GDP expectations to projected GDP for any market.

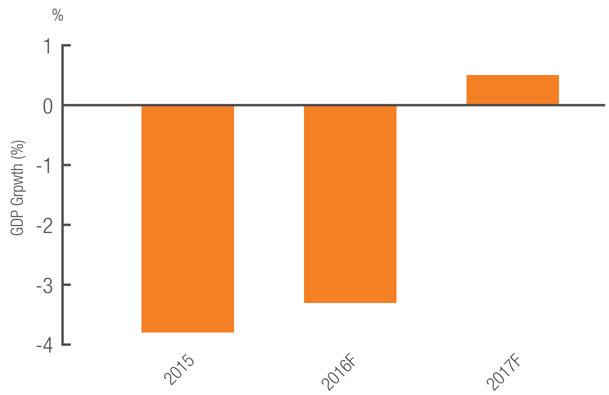
The positive sentiment and potential economic growth in 2017 are signs that Brazil may be on its way to recovery. Although the economy is still very fluid and many challenges remain, there is evidence to support that Brazil is finally using fiscally responsible decision-making to reach its growth potential.

Chart 5: Brazil's Inflation Rate is Declining



Source: Banco Do Brasil. IPCA Consumer Prices, based on a 12-month period.

Chart 6: Brazil's Economy is Expected to Return to Positive Growth in 2017



Source: IMF World Economic Outlook, October 2016 Edition.
F=Forecast. Forecasted numbers are projections and not guarantees.
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Definitions and Important Information

Basis Point (bp) is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument.
Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.
Past performance is no guarantee of future results.
Investment Risk — There can be no guarantee that any investment strategy (risk management or otherwise) will be successful. All investing involves risk, including the potential of loss of principal.
Emerging Markets Risk — The risks of foreign investments are typically greater in less developed countries, which are sometimes referred to as emerging markets. For example, legal, political and economic structures in these countries may be changing rapidly, which can cause instability and greater risk of loss. These countries are also more likely to experience higher levels of inflation, deflation or currency devaluation, which could hurt their economies and securities markets. For these and other reasons, investments in emerging markets are often considered speculative. Similarly, investors are also subject to foreign securities risks including, but not limited to, the fact that foreign investments may be subject to different and in some circumstances less stringent regulatory and disclosure standards than US investments.
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