The New Momentum in Orbiting Brazil

By JONATHAN FUERBRINGER

INVESTORS dread contagion in emerging markets. But barely four weeks into 2003, Brazil is showing that living close to a big debtor can be good for its neighbors' health.

"The direction Brazil takes will govern to a large extent the way perceptions of Latin America go," said Mohamed El-Erian, who as head of emerging market portfolio management at Pimco has bought millions of dollars in Brazilian bonds.

Although the election of Luiz Inácio Lula da Silva signaled a sharp turn to the left in Brazil, the new resident has done everything an investor could want. His key appointees have been "technocrats and orthodox economists," said Mr. El-Erian. "The policy implementation is totally in line," he added, noting decisions to increase social spending by delaying the purchase of jet fighters and canceling highway projects.

The central bank reinforced that conclusion last week, raising its benchmark interest rate half a percentage point to 25.5 percent. Despite the threat to economic growth from higher rates, the government backed up its promise to curb inflation.

That orthodox performance has paid off for some of Brazil's neighbors, as well as for Brazil itself, as the fear of a debt default by Brazil has waned. Three big bond sales, $2 billion from Mexico, $1 billion from Chile and $500 million from Colombia, have gone well in this improved environment, said Jose M. Barrionuevo, director of emerging markets strategy at Barclays Capital.

The total return on J. P. Morgan's index of Brazilian bonds is 0.7 percent so far this year and 43.9 percent since just before the October election. Other Latin bonds are faring well, with Peruvian bonds showing a total return of 0.9 percent this year.

Mr. El-Erian said fragile economies like Peru could benefit further from developments in Brazil. Pimco's $436 million Emerging Markets Bond fund bet 5 percent of its assets in Peru at the end of November, a huge bet for such a small country.

But even Brazil's good performance, Mr. Barrionuevo said, will probably not help Ecuador, which defaulted on its debt in 1999.

Ecuador's new president, Lucio Gutiérrez, is a left-leaning retired Army colonel who led a coup that toppled President Jamil Mahuad in 2000. But like Mr. da Silva, Mr. Gutiérrez has been pragmatic, dropping proposals to scrap Ecuador's dollarized currency and to not make payments on foreign debt.

ALTHOUGH Ecuador's bonds have rallied this year on hopes for new aid from the International Monetary Fund, Mr. Barrionuevo does not think Mr. Gutiérrez can win approval of the strong fiscal
measures needed to get assistance from the I.M.F.

Mr. El-Erian is avoiding bonds from Venezuela, which is in the midst of a nationwide strike against President Hugo Chávez, and those from Argentina, because of the risk of further declines.

There is, however, a lot of value in Brazilian debt, despite its recent rally, Mr. El-Erian said. He would not disclose how much Pimco has invested overall in Brazilian bonds.

But Pimco's emerging market bond mutual fund, had 22.8 percent of its assets in Brazil in November. That is up from 20 percent in November and more than the 16.1 percent share in one of the fund's benchmarks, the J. P. Morgan index. Including investments in its non-mutual fund accounts, Pimco holds $9 billion in emerging market debt.

Of course, he warned, Mr. da Silva has not proven he will stay this orthodox course. And investors could flee the risk of Brazil during a war with Iraq. "Then Brazil would suffer just like other countries," he said. Such a fear-of-war selloff sent Brazilian bonds sharply lower Friday.