Pimco Sees Legs on Brazil's Rally as the Real Hits a 2016 High

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By Aline Oyamada

(Bloomberg) -- Brazil's real, already the world's best- performing currency this year, touched a 2016 high after Pacific Investment Management Co. pondered whether Latin America's largest economy is a "comeback kid" capable of scoring a credit- rating upgrade.

The real rose 0.5 percent to 3.1061 per dollar at 4:13 p.m.

in Sao Paulo, its strongest level since July 2015. Three-week implied volatility on the real advanced 0.78 percentage point this week, to 15.7 percent, the second-highest in the world.

Pimco's vote of confidence, albeit with a few cautionary caveats, is helping to reinvigorate investor appetite for a currency that has climbed 28 percent this year. It adds to a string of positive developments in recent weeks that has prompted traders to reassess bets that Brazil's rally may be over, from President Michel Temer's success in advancing a spending-cap bill to last week's rating upgrade for the battered state-run oil giant, Petroleo Brasileiro SA. The central bank signaled Tuesday that it'll be modest in its quest to lower borrowing costs -- the benchmark rate is 14 percent -- which also supports the real.

"A better-than-expected improvement on the fiscal outlook and the slower-than-expected pace for interest-rate cuts both strengthen Brazilian assets," said Andres Jaime, a strategist in New York at Barclays Plc. Back in September, "we had a less optimistic outlook."

In a note on Pimco's website, emerging market portfolio managers Yacov Arnopolin and Lupin Rahman wrote that Brazil's high interest rates offer a "decent cushion against potential weakness." Borrowing dollars to lend in reais has returned 40 percent in a so-called carry trade this year, the most among major currencies.

"The country's fixed-income assets continue to present compelling opportunities," they wrote. "With confidence in the government returning, Brazil could be set for a comeback -- one that could restore nominal interest rates to single digits and put credit rating upgrades back on the table."

Local government bonds have been one of this year's most rewarding emerging-market trades, returning 61 percent in dollar terms, for investors who could take part. All the optimism on Brazil is luring money to the country. Dollar inflows in the first three weeks of October reached $2.5 billion, after a $6.8 billion outflow in the two previous months, and the central bank forecasts net foreign direct investment will pick up to $6.5 billion in October from $5.2 billion last month.

"The outlook for inflows has improved," said Gustavo Rangel, the New York-based chief economist for Latam at ING Financial Markets LLC.

Since the end of the first half, economists have raised their forecasts for the real against the dollar more than for any of the 56 other currency pairs tracked by Bloomberg. Still, the currency is expected to decline 6.9 percent by the first quarter of the next year, the most among major currencies, according to estimates compiled by Bloomberg.

Swap rates on the contract maturing in January 2018, a gauge of expectations for interest-rate moves, rose 0.08 percentage point to 12.24 percent.

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