
mar
asset
letter: august, 2024
Novelty is the Normality

And you run, and you run to
catch up with the sun

But it's sinking

Racing around to come up behind you again

The sun is the same in a relative way

But you're older

Pink Floyd, Time

The most significant innovation, though not entirely new, introduced by global economic policies to counter the economically catastrophic effect of lockdowns during the COVID-19 pandemic was the unprecedented use of fiscal stimulus.

In recent decades, monetary policy has increasingly supplanted fiscal measures as the dominant tool for stabilizing economic cycles. Over time, economic policy decision-making has shifted from politicians to technical experts with greater autonomy from government influence.

This shift was a result of acute inflationary events triggered by fiscal expansion policies that were primarily motivated by the political cycle. As Milton Friedman said, “There’s nothing as permanent as a temporary government program.”.

Since then, fiscal policy, managed by elected politicians with diffuse objectives, gradually lost its prominence in favor of monetary policy, managed by teams of experts with objectives independent of political mandates.

The inflation-targeting framework and the independence of central banks contributed to an improved economic management, reducing GDP and inflation volatility. Simultaneously, advances in mathematical models provided economists with valuable tools for better interpreting economic realities. These developments led to more efficient policies over the years, enabling better planning, particularly for long-term investments, by economic agents.

However, as we know, history and economic cycles always bring surprises, and the most recent one we experienced was the pandemic.

In light of the dramatic potential impact that lockdowns could have on the economy, governments not only relied on monetary tools, as they did after the 2008 financial crisis, but also brought back fiscal stimulus with full force.

The scale of government disbursements was unprecedented.

In addition to the magnitude of the stimulus, its form was also unique. In past events of major fiscal expansion, such as the New Deal in the 1930s, governments injected money into the economy through large infrastructure projects. During the pandemic, however, the model was different. Due to physical isolation, the most efficient way to inject resources into the economy was through direct transfers to households, particularly low-income families, and small businesses.

As a result, the economic forecasting models developed over the past decades, which were largely based on monetary tools, had to contend with the return of fiscal stimulus in an unprecedented magnitude and form, with limited historical data to draw upon.

The consequence was that the models failed to serve as effective tools for understanding and predicting recent economic behavior.

At Mar, we spend a considerable amount of time understanding and utilizing available models, and we are always keen to identify the specific problem each model was designed to address, along with its underlying assumptions. This approach helps us better understand their limitations and recognize the environments in which they might perform more, or less effectively.

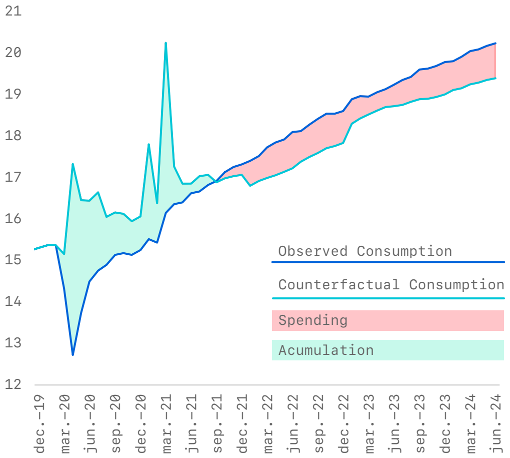
A major challenge for the models was the behavioral shift caused by lockdowns, which led families to delay spending the money transferred by governments.

The scale of these transfers resulted in most families having higher income levels than before the pandemic, but without the mobility to spend it. As a result, a substantial, excess savings pool was created globally.

In the U.S., for instance, this savings pool reached as much as 9% of GDP.

Figure 1:
Excess Savings Formation

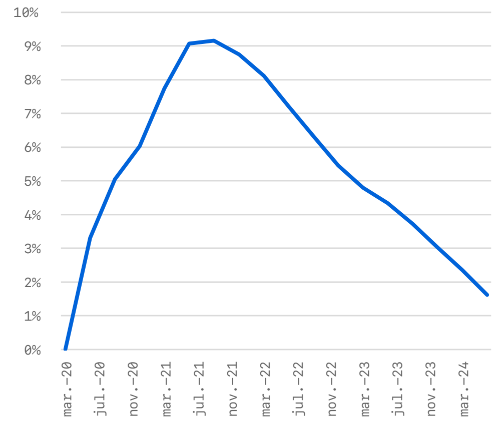
$, trillions



Source: BEA, Mar Asset Management

Figure 2:
Excess Savings as % GDP

% GDP



Source: BEA, Mar Asset Management

From another perspective, the fiscal expansion by governments did not immediately impact the economy in full force. Even though most governments halted extraordinary spending in the following years, households continued to consume their excess savings. It was as if the government's fiscal stimulus gradually affected the economy, with its impact staggered over the years following its implementation.

Naturally, the models were not calibrated for such an unprecedented situation. They operate in a simplified way, focusing on the fiscal impulse — defined as the difference between the government's fiscal expansion in one period compared to the previous one. If the government spends more in the current year than in the previous year, the impact on GDP is positive, and vice versa

In the post-pandemic period, even though governments reduced their spending after the worst phase of the crisis, the consumption of excess savings continued to positively impact economic growth for several years.

In our view, the gradual consumption of the fiscal stimulus is the reason behind the positive growth surprises that were not anticipated by the markets.

While the models predicted a sharp economic slowdown due to rising interest rates and reduced government spending, the reality was one of strong demand fueled by the consumption of excess savings.

The unexpected surge in demand sparked intense debate about the true potency and lag of monetary policy, which, in fact, never fully materialized as expected.

The heated discussion around the delayed effects of monetary policy, higher neutral interest rate hypotheses, deglobalization, and decarbonization—factors proposed to explain more persistent inflation—seems to stem from the surprise generated by the resilience of strong growth amidst restrictive monetary policy and negative fiscal impulse.

However, we believe that this time the models failed to account for the lagged effects of fiscal expansion rather than monetary tightening. Our best explanation for this growth resilience is not tied to any structural factors, but rather to conjectural ones.

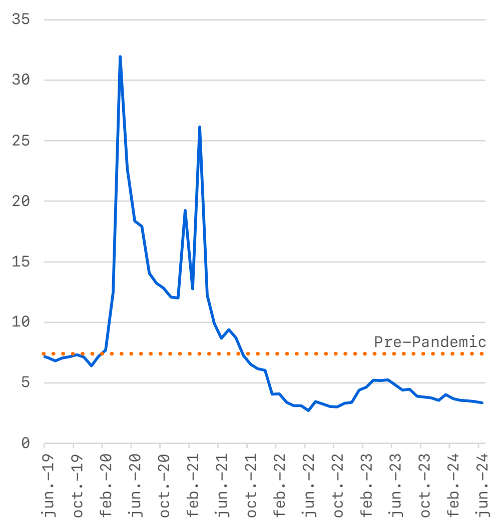
The magnitude of the fiscal stimulus, which was transformed into substantial excess savings, is what made it difficult for the models to predict stronger and more prolonged growth.

The noise variable, excess savings, is finite. Eventually, it would be depleted, and naturally, we would return to an environment more similar to the pre-pandemic one. Thus, once this “anomalous” variable disappears, we would be back to an economy where the available models would regain their high level of accuracy.

We believe that we have reached this point. The excess savings have been nearly exhausted, and as a result, restrictive monetary policy will start to be more effective in reducing demand.

Figure 3:
Savings Rate

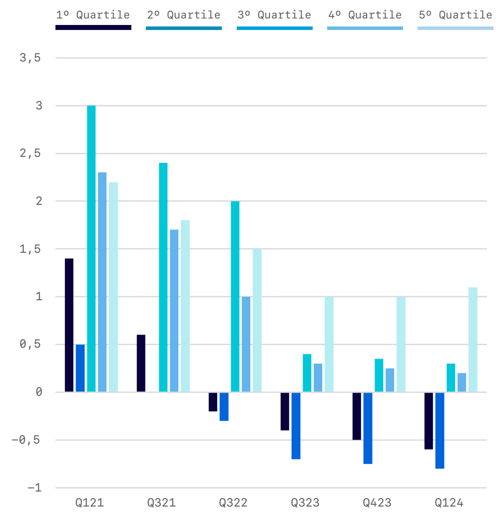
% disposable income



Source: BEA, Mar Asset Management

Figure 4:
Deposits in Bank Accounts and Money Market Fundsand Money Market Fund Shares by Income Quartile

% PCE, Z-score



Source: BEA, UBS, Mar Asset Management

The low predictive accuracy of the models in recent years has caused them to lose credibility among policymakers and portfolio managers. We believe that now is the time to restore confidence in economic theory and return to traditional portfolios.

The 60/40 Portfolio as a Sign of Economic Normality

The 60/40 portfolio performs well in most economic environments. It consists of a portfolio made up of 60% equities and 40% long-term fixed-income securities.

The idea is that, during economic crises and increased risk aversion periods, interest rates fall, and the gains from fixed income protect against losses in the equity portion. Meanwhile, in an environment of economic growth, equities tend to appreciate significantly more than the losses generated by rising interest rates.

It is worth noting that, since the 1980s, the U.S. has not experienced significant inflationary periods. Until 2021, the 60/40 portfolio navigated different market cycles brilliantly, including economic accelerations and decelerations, various crises, and strong interest rate cycles by the Federal Reserve.

However, it faltered in the post-pandemic period.

Inflation is the kryptonite of the 60/40 portfolio because interest rates rise to slow economic growth, which causes equity prices to fall. In such a scenario, both asset classes suffer losses.

High inflation is unusual in a well-managed and highly efficient economy like the U.S., but the pandemic was an exception that temporarily disrupted well-established frameworks.

With the depletion of excess savings and the normalization of inflation, the 60/40 portfolio will once again be an efficient method of capital allocation, reinforcing the sense of economic normality.

The high rates implied by the yield curve provide a powerful portfolio protection tool against an unexpected economic slowdown. As Jerome Powell mentioned in his latest press conference, the current level of interest rates puts the Fed in a comfortable position to combat an unexpected rise in unemployment, as there is ample room for rate cuts.

Bumps in the road

The expectation of a return to normality was the rationale behind our decision to receive the short-term U.S. interest rates in the second half of the last year[1].

This normalization process has been anticipated in the U.S. due to the strong influx of foreign workers. This labor flow has smoothed the disinflationary process, as the excess demand generated by the consumption of excess savings has been offset by the increased supply of

1 Refer to our letter "Land in sight?" – published in December, 2023 for a detailed discussion.

labor, keeping wage growth under control and preventing an inflationary feedback loop.

The hypothesis of labor market rebalancing, as advocated by Jerome Powell in his recent press conferences, combined with the depletion of excess savings, forms the basis for our thesis of a return to economic normality. This will prompt the Fed to normalize its monetary policy, which is currently in a restrictive stance.

This process has not been smooth, and as a result, the performance of the Mar Absoluto strategy has been volatile. During the fourth quarter of 2023, our positions performed well, as the normalization thesis gained traction both in the market and in economic discussions.

Initially, some Fed officials, such as Governor Waller, voiced support for this view. Eventually, Chairman Jerome Powell explicitly endorsed it during the press conference following the Fed's December meeting. At that point, the markets and the yield curve reacted strongly in our favor, and we performed accordingly.

However, the first quarter of 2024 proved to be very different from what we had anticipated. Our expectation of a continued slowdown in the labor market and the disinflationary process was upended by the release of unexpectedly strong employment and inflation figures.

The magnitude of these surprises cast doubt on the thesis of the U.S. economy's slowdown and normalization. For instance, January's payroll report showed a net creation of 353,000 new jobs in its initial release, significantly above the previous month's average of around 215,000 and inconsistent with labor market equilibrium. Core PCE inflation, which had been running near 2.0% on a yearly basis in the second half of 2023, rose to 3.4% in Q1 2024.

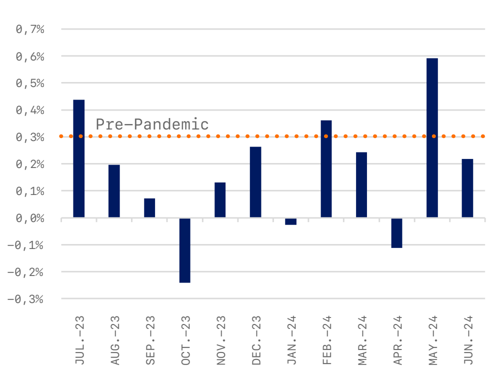
Among the three possible scenarios—reacceleration of activity (no landing), soft landing, and hard landing—the reacceleration narrative gained renewed traction among economists and market participants.

Asset prices reflected this shift in perception. Markets reacted aggressively, even to the extent of removing any expectations of rate cuts from the yield curve. Prominent economists, including Larry Summers, publicly warned of the potential for further interest rate hikes on the horizon.

Despite this, we found it difficult to envision a scenario of reacceleration for 2024. Excess savings had been depleted, real wage growth had returned to pre-pandemic levels, households' savings rate was historically low, and fiscal impulse would either be neutral or negative. In our view, there were no engines left to sustain growth above the economy's potential.

Figure 5:
Real Wage Growth in the U.S.

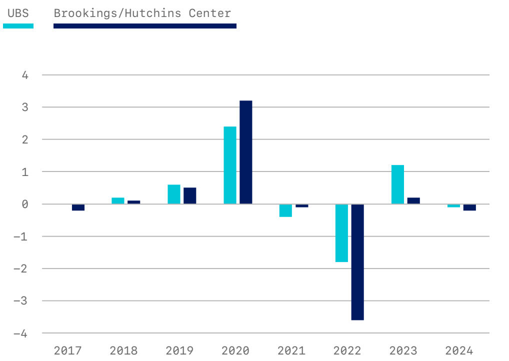
%, m/m



Source: BEA, Mar Asset Management

Figure 6:
Traditional Estimates of Fiscal Impulse

% GDP



Source: Brookings, UBS, Mar Asset Management

Nevertheless, we reduced our received positions to take a closer look at recent data and better understand whether there was anything that contradicted our thesis.

As more data became available, we gained confidence that the strength of the early-year figures appeared to be more noise than signal. Changes in the seasonality of employment data, price adjustments, and other distortions arising from post-pandemic shifts in patterns had a significant effect on the release of stronger-than-expected readings for both activity and inflation.

Our view is that the normalization of an economy without stimulus should continue after these "bumps in the road," allowing the Fed to eventually start its interest rate reduction cycle.

As a result, we resumed our received positions at a magnitude similar to what we had at the beginning of the year.

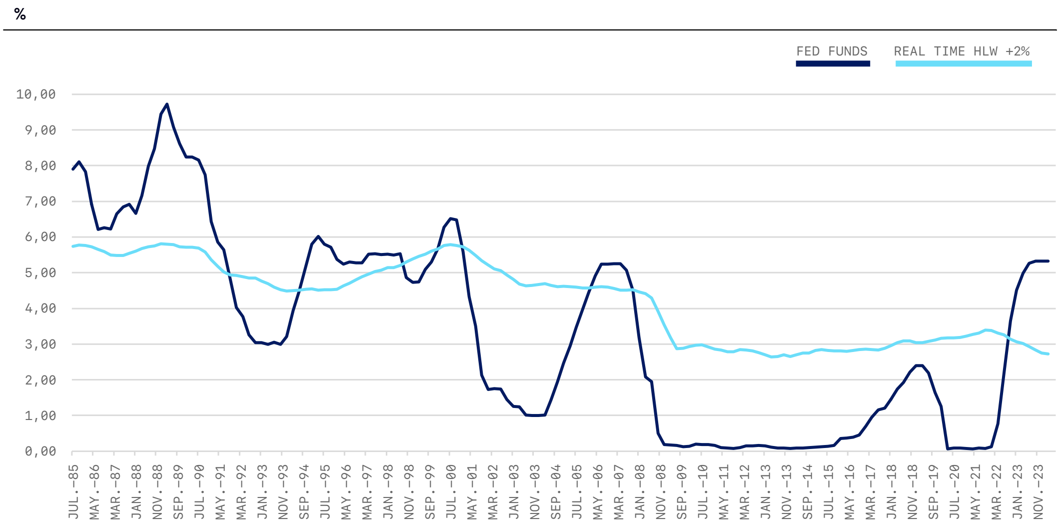
Hard landing is the normality

The probability that the market assigned to the three possible scenarios—economic reacceleration, soft landing, and hard landing—shifted throughout 2024. While the central scenario in the markets remains the soft landing, the probability of reacceleration has gradually been transferred to the likelihood of a hard landing.

We believe that the risk of a policy mistake, with excessive monetary tightening leading to a hard landing, is significantly higher than the possibility of a reacceleration of economic activity, given that the growth drivers are no longer present.

In major monetary policy cycles, it is common for central banks to raise interest rates to levels well above the neutral rate to curb inflationary pressures, and then lower them below the neutral rate to counteract excessive deceleration. A soft landing following an aggressive tightening cycle has rarely occurred in history. More often, we observe a more severe contraction than desired (a hard landing), prompting the Fed to act to mitigate the downturn.

Figure 7:
Interest Rate Cycles and Estimated Neutral Rate



Source: U.S. Department of the Treasury, Mar Asset Management

The possibility of the Fed eventually lowering rates into stimulative territory has been little discussed in the market due to the repeated positive growth surprises we've experienced in recent years. If we are correct in assuming that these surprises were the result of delayed effects from fiscal stimulus and the abrupt increase in immigration, it would be natural, given the current interest rate levels, to see the end of the rate-cutting cycle with the Fed Funds rate below the neutral rate.

Numerous historical parallels exist where interest rates shifted from restrictive to stimulative within the same cycle. The rate-cutting cycle of 2001 shares important similarities with the current situation. It's interesting to note, from transcripts of Fed meetings in late 2000 and early 2001, how the discussions among FOMC members resembled the debates we're having today.

At the time, the Fed raised the Fed Funds rate to 6% after a period of strong economic growth, inflation had remained above target for several consecutive quarters, and there was uncertainty among policymakers about the neutral rate. When the initial signs of a slowdown emerged—despite unemployment being low and GDP still growing—the Fed decided to initiate a small rate cut as an initial adjustment to at least reduce the level of monetary restriction.

Then, the dotcom bubble burst (which could have a modern parallel), and what began as a minor adjustment to avoid a marginal slowdown ended with the Fed Funds rate at 1.75% in December 2001.

Our view of a return to economic "normality" is also reflected in our belief that there has been no significant change in the neutral interest rate.

Similar to the late 1990s, the resilience of U.S. economic growth amid current interest rates has led to various hypotheses to explain the phenomenon, and once again, economists and markets have adopted the consensus that the neutral rate has increased.

We are skeptical of this thesis. The long-term neutral interest rate of an economy is tied to structural factors such as demographics and productivity, which have not changed significantly between the pre- and post-pandemic periods.

On the other hand, the short-term neutral rate responds to short-term variables, such as fiscal expansions and contractions.

For this reason, it seems plausible that the short-term neutral rate did rise due to the strong fiscal stimuli during the pandemic. Now that these stimuli have finally been exhausted, we should see the short-term neutral rate move closer to the long-term neutral rate.

If this assessment is correct, monetary policy is becoming more restrictive passively—both through declining inflation, which raises the real interest rate, and through the short-term neutral rate declining, increasing the gap between it and the current Fed Funds rate.

In this case, it would become clear over time that the Fed would need to lower its interest rate, potentially below the neutral rate, if a slowdown is stronger than consensus expectations.

Even in the event of a recession, we would still be dealing with an economic normalization process, where high interest rates would have their intended effect on reducing demand, and rate cuts would be the most effective tool to stimulate a recovery.

As we return to an economic framework in which monetary policy once again plays the dominant role, while fiscal policy takes a back seat, we would confirm the re-establishment of a 'normal' environment, where changes in the overnight interest rates, set by central banks, serve as the primary instrument for stimulating or restraining consumption and investment.

The Impact of Global Normalization on Brazil

Except for the Artificial Intelligence (AI) thesis, asset prices in recent years have largely responded to a limited number of global macroeconomic variables. Due to the synchronization of global economies, macroeconomic decisions have defined the dynamics of different asset classes across various geographies.

The correlation between asset classes has increased significantly, as the most important variable for global asset pricing, U.S. interest rates, remains “out of place.” Until we see its normalization, assets will primarily react to expectations around the Fed’s actions.

For this reason, we have decided to focus on studying the dynamics of the U.S. economy. Since the key variable driving both macroeconomic and microeconomic factors in Brazil is now the Fed's actions, it no longer makes sense to operate in local assets without having a well-informed opinion on the primary source of risk.

The consequence of this global economic normalization will be the end of economic synchronization and the beginning of differentiation between countries. Each country will experience its own specific cycle of demand expansion or contraction, driven by variables intrinsic to its economy[2].

From this perspective, Brazil's situation becomes even more complex, especially concerning the transition from fiscal policy leadership back to monetary policy dominance.

Brazil is facing this transition during the early stages of a new political cycle. A left-wing government was elected with half of the valid votes and minimal representation in parliament. As a result, the new administration's only tool for maintaining governance has been increasing its popularity.

President Lula's government understands that its popularity is closely linked to economic growth, which, in turn, has been driven by expanded government spending[3].

In Brazil, we have not seen an end to expansionary fiscal policies post-pandemic. Instead, since Lula's election, there has been a sharp increase in government spending, even though the economy was already operating above its potential, with a positive output gap and a tight labor market.

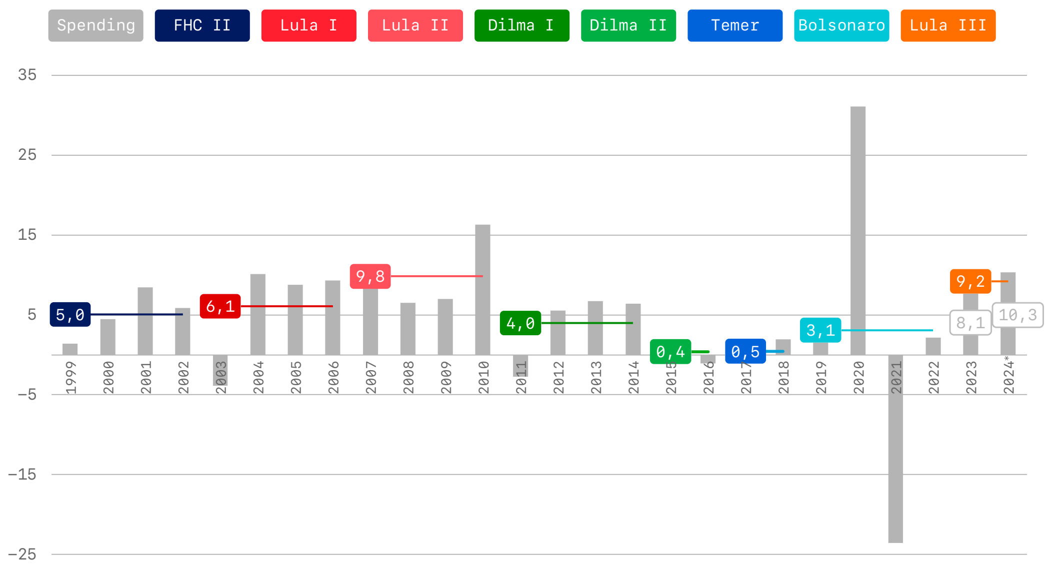
The first two years of Lula's government brought positive surprises in GDP growth, but unlike the U.S., it was the government that continued to pressure demand through recurring fiscal stimuli.

2 This topic was explored in greater depth in our letter "Fasten Your Seatbelts, Are We Landing…?" from September 2023.

3 For more details, refer to our letter "There shines a star… a falling star?" from February 2023.

Figure 8:
Growth of Central Government Spending

%, real, yearly



*Consideramos as despesas do pagamento de estoque de precatório feitas em dezembro de 2023 como despesa de 2024, pois o foco é o impulso fiscal e as consequências desse pagamento serão mais claras neste ano.

Source: National Treasury of Brazil, Mar Asset Management

The maintenance of GDP above its potential led to a sharp decline in the unemployment rate—another difference compared to the U.S.—bringing it down to levels similar to the lowest seen during the Dilma administration.

We have written an extensive study in which we share the reasons behind Brazil's disinflationary process occurring alongside strong GDP growth and a decrease in unemployment[4].

The economists have answered by arguing that Brazil's potential GDP has increased, citing well-behaved inflation despite strong growth. The reasoning behind this improvement in potential output is attributed to the series of structural reforms passed since the Temer administration.

As in the debate on long-term neutral interest rate, we do not believe that structural factors have changed significantly enough to justify the exceptionally high GDP growth seen in recent years.

4 Letter: "Soft landing em perspectiva: o caso do Brasil", Maio de 2024.

In Brazil's case, the slowdown in demographic growth, which has fallen from around 2% per year in past decades to closer to 0.5% today, is the main variable explaining our decline in potential GDP.

Unfortunately, a potential GDP that previously ranged between 2% and 3%, though positively impacted by reforms, has been negatively affected by the drop in demographic growth, which is a dominant factor in determining this variable.

In our study, we argue that Brazil's disinflationary process is largely the result of global disinflation, which has impacted the prices of imported goods and those indexed to the dollar. This global trend has also spilled over into local service prices through inertia in producer price indices, such as the indexing of rents and condominium fees to the IGP-M[5].

While this disinflationary effect helps control inflation, it is temporary. We observed a similar phenomenon during Henrique Meirelles' interest rate-cutting cycle in 2005.

At that time, a significant appreciation of the real had a strong disinflationary effect on imported goods, creating the false perception that strong GDP growth alongside low inflation was a sign of increased potential GDP or a reduction in the NAIRU (non-accelerating inflation rate of unemployment).

Once the currency appreciation ended and imported prices stopped falling, service inflation began responding to the internal economic dynamism, rising permanently in 2007. It was only effectively controlled during Ilan Goldfajn's tenure in the Temer administration from 2016 onwards.

Currently, Brazil faces an underlying inflationary environment, built through a series of fiscal stimuli, alongside a temporary and superficial disinflationary process influenced by falling global prices, which is nearing its end. Our economy is operating above its potential, unemployment is moving toward levels increasingly incompatible with balanced prices, the government is under pressure to boost its popularity in the final stretch of

5 Brazilian General Price Index published by Getúlio Vargas Foundation.

its mandate, inflation expectations are already significantly above target, and the new composition of the Monetary Policy Committee (Copom) has diminished credibility with the market.

There is a significant risk of an inflationary process emerging in Brazil in the short term, with limited capacity for the Central Bank (BCB) to respond, either due to political constraints imposed by the current government or the continuation of government spending expansion.

The timing of Brazil's inflation flourishing appears to be highly dependent on the actions of the Federal Reserve in the coming months. Should the Fed begin a rate-cutting cycle, as we anticipate, it would be natural to observe a new round of appreciation of the Brazilian real, which could help contain internal inflationary pressures for a while longer.

However, if the Fed delays its rate cuts, a strong U.S. dollar would exert pressure on emerging market currencies, particularly the Real, potentially amplifying Brazil's inflationary forces.

Unlike the U.S., we see significant fragility in Brazil's macroeconomic situation. The underlying issue is largely the continued expansion of fiscal policy aimed at stimulating domestic demand at a time when the Central Bank of Brazil (BCB) was seeking to decelerate consumption.

The justification for initiating an interest rate-cutting cycle, despite rising inflation expectations, falling unemployment, and accelerating GDP[6], was far from straightforward.

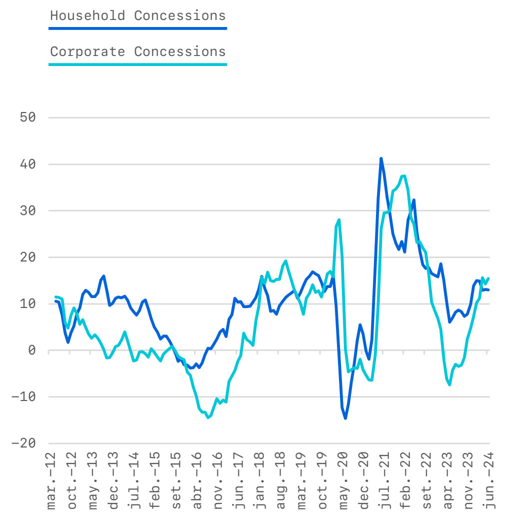
The BCB argued that the drop in the unemployment rate to near-historic lows did not necessarily indicate an overheating economy. Even if it did, the bank believed that unemployment was a lagging indicator and would respond to the eventual slowdown in activity, already set in motion by the previous rate hikes. The BCB also argued that controlled wage inflation signaled that the labor market was not overly tight, and that credit was decelerating as expected after the increase in the Selic rate.

6 We discussed this point extensively in our letter "Not necessarily about monetary policy" from June 2023.

However, both arguments have not held up. Economic activity did not slow as predicted, credit rebounded sharply following the rate cuts, and inflation expectations continued to drift upward. At the same time, wage inflation indicators remained elevated, at levels incompatible with sustainably achieving the inflation target.

Figure 9:
Growth in Non-Earmarked Credit Concessions

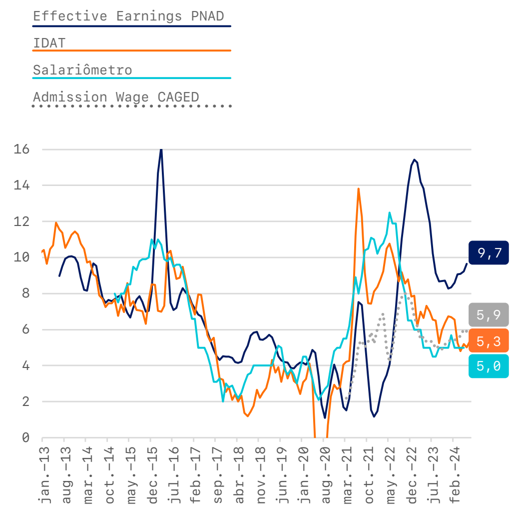
%, yoy, 3MMA



Source: BCB, Mar Asset Management

Figure 10:
Nominal Wage Inflation

%, yoy



Source: IBGE, Itaú, Ministry of Labor and Employment, Fipe, Mar Asset Management

Even so, current IPCA inflation remains relatively well-behaved, in our view, due to global disinflationary trends. However, we do not know how long this will last.

The Political Cycle

Observing the political cycle is essential when investing in emerging markets. While the next Brazilian presidential election may seem distant, it is already capturing our attention. Starting in the second half of next year, we expect market prices to begin reflecting expectations surrounding the election.

This introduces a delicate balance of forces in Brazil's economic policy decisions. If President Lula's government opts to increase government spending to boost popularity ahead of the election, it could lead to macroeconomic instability, given the fragile inflationary and fiscal environment.

Such volatility could reduce the president's popularity and increase the likelihood of an opposition candidate, such as São Paulo Governor Tarcísio de Freitas, winning the election.

This dynamic could, or should, constrain the current government from implementing more reckless measures. In a scenario where Lula goes 'all in,' the market might begin to anticipate his eventual defeat and the victory of a more fiscally responsible administration.

For this reason, we believe that the approach of the elections, unlike in other cycles, could reduce price volatility and allow stocks to perform more in line with operational results rather than macroeconomic decisions.

Within this context, we see unique investment opportunities in Brazilian companies managed by excellent executives, with significant potential for good capital allocation, and trading at implied rates of return that we have rarely seen before.

Once again, the differentiation between U.S. and Brazilian cycles reaffirms our perception of a return to normality, where each economy operates based on its own fundamentals and peculiarities, rather than in a synchronized manner.

After a period of high correlation between economic cycles and asset prices, we expect an increasing decoupling between asset classes. Alpha generation through stock picking and country-specific investment theses will become the norm again.

mar
asset

Investors Relations
Igor Galvão
55 21 99462 3359
contato@marasset.com.br

rio de janeiro – rj – av. ataulfo de paiva 1165 / 801, leblon – 22440 034
marasset.com.br