newsletter: June, 2023

Not necessarily about monetary policy

Recently, we have added yet another phrase to our blacklist here at Mar Asset: “not necessarily”.

This concept was skillfully discussed by Ray Dalio in his book, “Principles”: “When you ask someone whether something is true and they tell you that it’s not totally true, it’s probably by and large true”.

In dialogues involving ideas, there’s an inherent attraction towards dichotomy in terms of right or wrong, as if binary; “0 or 1”, where an idea can be totally refutable or unquestionably true. We engage in a daily battle against this natural and polarizing attraction, striving to analyze ideas from a probabilistic standpoint rather than a deterministic one. Thus, much like Dalio, whenever it is argued that an idea is “not necessarily” correct, we interpret it as an indication of its validity. If the idea is generally correct, even if not necessarily so, we are on the right path.

The current debate on future monetary policy decisions in Brazil frequently features this binary pair of right or wrong. Our somewhat old-fashioned opinion that the Central Bank of Brazil (BCB) should wait longer than what the market expects to initiate a possible interest rate cut cycle has faced numerous valid criticisms. The most interesting one suggests our way of thinking might align too closely with the more orthodox economists, and that the cost of such orthodoxy is not compatible with the pragmatic reality of socioeconomic policy.

In the context of debating, it is worth highlighting Gabriel Galípolo, heterodox economist and recently appointed to spearhead the monetary policy office. This economist, with a vast and diversified repertoire, has made observations and reflections, in various speeches and podcasts, on monetary policy that we consider correct and pertinent. Notably, he questions the supposedly deterministic approach that economics has evolved into with advancements to modeling, despite economics being essentially a social science.

The dogmatic belief in models can push us away from the reality of socioeconomic policy.

We at Mar Asset share this reflection. However, from this viewpoint, a question arises, about which we might disagree with the new director: how should we react to this inevitable uncertainty? Should we ignore the models? Or should we employ them as tools to guide us amidst uncertain and turbulent scenarios?

If the theoretical structures and economic identities are not unquestionably correct but, in general, provide effective frameworks for mental organization, comprehension, and reflection on complex problems, then we believe they are useful enough to participate in our analysis – even if in a critical or cautious manner.

The risk of using the phrase “not necessarily” as the chief argument to discard existing models is that it minimizes the perceived cost of testing new solutions that promise superior results at lower costs.

Experimentation is a key part of societal evolution, often leading to revolutions. However, as with every experiment or revolution, the risks involved are considerable and, when rationally assessed ex-ante, should be avoided nine out of ten times.

So, we have listed some key points related to the scenario informing the BCB’s decision to begin the interest rate reduction:

1. The *IPCA* (Broad National Consumer Price Index) inflation has been upsetting expectations of reduction.
2. The BRL has picked up momentum even upon the drop in commodities.
3. The *IGP-M* (General Market Price Index) is in a steep fall.
4. The interest rates have been kept very high for a long period – more specifically, the real ex-ante rate (the 1 yr. pre-fixed rate – 1 yr. *IPCA Focus*) have remained above 6% since November 2021, that is, for almost 20 months now.
5. The costs to maintaining high interest rates can be very harmful to the economy.
6. The BCB models show an inflation projection at around the target for the relevant time-frame.
7. Services inflation, associated with the new economic cycle, has been retreating, coming from a high level, but slower than expected by the BCB.
8. The fiscal tail risk (extreme events) was, supposedly, eliminated with the novel tax framework's approval in the Chamber of Deputies.
9. Notwithstanding high interest rates, the economic activity has surprised market analysts, showing itself more robust than foreseen, be it in the services sector and household consumption, or in agriculture, which somewhat affects the whole of the economy.
10. The job market is still strong, with income and wage bill growing above the level compatible with a process of sustained disinflation.
11. There is a strong permanent fiscal drive in 2023, only similar to 2009's.
12. The neutral interest rate may be higher than expected, making the current rate not so low.
13. Inflation expectations for the medium and long term are above the target.

Upon analyzing the aforementioned arguments, it becomes evident that some distinctly favor the initiation of an interest rate cut cycle, while others advocate for maintaining and extending the stability period.

Our approach, when faced with compelling technical arguments swinging both ways, is not to try and determine which will prevail, but to focus on the BCB's original objective and measure the potential deviation each might cause. This approach allows us to better understand the balance of risks facing the *Copom's* (Monetary Policy Committee) objective.

By doing this, we can sidestep the "0 or 1" dichotomy or the tempting "not necessarily", and lean toward the most likely scenario with less foreseeable cost for the BCB's singular objective.

Among the arguments favoring a cut in interest rates, our favorite is the surprising slowdown of services inflation seen late last year, despite incredibly resilient economic activity.

However, the strength of this argument also constitutes its greatest weakness or risk. The surprising degree of disinflation, without a compatible reduction in aggregate demand, weakens the premise that such disinflation is sustainable, increasing the likelihood of it being short-lived.

A reduction in inflation without an increase in unemployment can stimulate demand, as it acts like a positive supply shock, in turn increasing real income and providing more room for household spending.

The relationship between inflation and unemployment is one of the most emblematic in economics. In this relationship, called the Phillips Curve, a lower unemployment rate fosters inflationary pressure, and vice-versa.

Brazil has a long inflationary history and because of it, a high spread of current prices to future prices, depicting a structural rigidity of prices in the economy.

The greatest risk faced by a Central Bank in monetary policy management is allowing the creation or expansion of inflationary inertia. The greater and longer it is, the greater the cost, in terms of economic activity and unemployment increase – needed to bring inflation back to its target. In other words, avoiding short term pain may result in worse pain in the medium and long term.

Inflationary inertia is the nightmare of every central banker, given it is only verified ex-post, that is, after its occurrence.

So, how can a central banker wishing to avoid inflationary inertia know if its risk is increasing? How is it possible to identify the risk of its onset in advance, if it is a variable observed ex-post?

The best way to avoid inflationary inertia is for the Central Bank to maintain high credibility. With this in mind, monetary policy has been enhanced over

the years, evolving into the inflation-targeting model. The most appropriate measure in relation to the Central Bank's credibility is keeping inflation expectations within the target for as long as possible, and that's why it's recommended to respond when it strays. The greater the credibility of a Central Bank, the lesser the impact from short-term price variations on long-term expectations, leading to smoother monetary cycles. The longer inflation strays from the target, the more unanchored future expectations become, necessitating more aggressive cycles.

In short, the Central Bank's credibility is crucial to inflation targeting, and losing it would be the tail risk to avoid, as it entails many high costs to the national economy, as experienced in Brazil between 2011 and 2016.

The traditional approach to monetary policy transmission occurs by altering interest rates, which affects the average cost of credit, reducing demand, influences unemployment, and adjusts wages.

In other words, to contain an inflationary process, the Central Bank raises interest rates, credit becomes more expensive, demand drops, unemployment increases, wages fall, and finally, inflation decreases.

Obviously, reality has the final say, and "not necessarily" do all steps of the process need to be checked for us to observe a disinflationary process. Even so, when we have the result – disinflation – without due verification of previous steps, the conviction that the disinflationary process is structural becomes considerably weakened.

Another relevant and frequently used argument to justify an interest rate reduction is the damaging social cost of keeping rates high for a prolonged period. From a monetary policy viewpoint, the social cost – the increase in unemployment, is associated with the convergence towards the inflation target. Currently, despite the intensity of criticism from market agents about the interest rates, the unemployment level is very low compared to our inflation history, at 8.1%, while total wage bill and real income are on the rise. Therefore, in terms of social costs, we do not see empirical evidence that should pressure the BCB into anticipating a significant interest rate reduction.

Even if the BCB's projection model ends up showing inflation around the target for the relevant monetary policy timeframe, it's important to

remember that historically, these models have repeatedly underestimated the actual inflation.

In 2016, former BCB president Ilan Goldfajn faced similar criticism and pressure to begin a rate cut cycle, but back then unemployment was clearly above the natural rate, at around 12%, and yet he waited until the level of uncertainty concerning disinflation diminished before proceeding with the monetary easing cycle.

Regarding the fiscal framework symbolizing the elimination of the tail risk in the debt/GDP dynamics, we find it hard to subscribe to it.

By projecting the public debt ratio according to the rule from the newly-approved fiscal framework, without any extraordinary tax collection, we would end the current presidential term with an 18 p.p. increase, taking the gross debt to 91% of GDP. Such variation is coincidentally equivalent to the increase generated throughout Dilma Roussef's six-year term, but with a very different starting point: while Dilma's administration began with 52% gross debt/GDP, currently, it sits at 73%.

In other words, the elimination of the tail risk is much more related to the intention of higher tax collection promised by the government than to the ability to adjust the public budget, promoted by implementing the fiscal framework rule itself.

That is why our approach focuses on assessing the risks that the BCB would consider in its monetary policy discussion.

Thus, it is hard for us to see the benefit for the current monetary policy board to risk anticipating a rate cut cycle before the economic vectors point in this direction.

We believe the most powerful argument for keeping the monetary stance is the level of uncertainty that the current moment presents, when we analyze economic data, especially the consumption's low sensitivity to monetary tightening.

As we have discussed before, it's surprising that, despite the real ex-ante interest rate having been above 6% for 20 months, demand has barely been affected by the monetary contraction. We must remember that the BCB's own monetary policy time-frame ranges from 12 to 18 months.

The aggregate demand's low sensitivity to the cycle is not solely a local puzzle; this same characteristic has been observed globally, due to the unprecedented scale of fiscal stimuli implemented during the pandemic. Some central banks in developed countries are extending their cycles after having announced the end of the contraction cycle.

In a way, it's as if those advocating for an anticipated onset of a rate cut cycle believe the monetary policy's lag for inflation is shorter than it is for demand, unemployment, and wages. As if the contraction effect "skipped" the intermediary phases and directly affected inflation—the final step in the process.

We agree that things in the economy don't always occur as expected. Even so, it still seems unlikely that a disinflationary process would occur in a sustainable way without us feeling some impact on the chain of events: a slowdown in activity, GDP growth below potential, an increase in unemployment, and wage reduction.

The risk associated with an anticipated rate cut cycle is that the current disinflationary process might be temporary, and the robust economic fundamentals could be bolstered by a potential rate cut and become a formidable barrier to inflation reduction or even an inflation booster, especially if there are any changes in the favorable international scenario.

Society typically assesses a central banker retrospectively, seldom remembering the contextual motivations that guided their past decisions. The key evaluation measure is whether they were able to keep inflation close to the target and avoid growth in inflationary inertia. The paths taken by the US's Arthur Burns and Brazil's Alexandre Tombini are remembered as examples of central bank leaders who, by trying to excessively

alleviate costs to curb inflation, invoked even more social costs by not meeting their targets.

In contrast, former BCB president Ilan Goldfajn's tenure—despite facing heavy criticism at the time for taking too long to start the rate cut cycle (a 15-month wait between the end of the higher rates cycle and the first rate cut in a high unemployment scenario)—was later praised. He ended his term receiving compliments for having kept expectations under control and for having managed to reduce the Selic rate (Special System for Settlement and Custody) to its lowest level to date.

Unfortunately, the only way to assess a central banker's risk management is over time and by monitoring the consequences of their decisions. The current BCB administration has been criticized for having been overly dovish during the easing cycle. It seems risky that the same mistake might be made twice in the same direction: anticipate the easing cycle, based on current inflation drop without considering the fundamental variables that indicate the process's sustainability.

In our view, for a central bank, whose main goal is the inflation target and the resulting prevention of inflationary inertia, this would represent an asymmetrically negative risk.

Still, not necessarily, the BCB would be wrong to anticipate a loose cycle in a moment of creeping real wage bill growth, repeated positive surprises in the activity level, uncertainties about the neutral interest rate level and unanchored long term inflation. However, generally speaking, it does seem sensible to avoid the belief that "this time is different" and postpone the easing cycle for longer, aiming at collecting more information and dissipating uncertainties hovering above this cycle's beginning.

This is particularly important to mitigate society's perception that the BCB can make decisions out of political pressure, which could jeopardize its credibility and consequently lead to a change in the implicit inflation target perceived by the market. In times of important adverse signs and long tails risk present, we believe patience, consistency and moderation are useful concepts to be considered by policy makers.

FIGURE 1:
Table from President Roberto Campos Neto's presentation on 6/5/2023. Economic indicators suggest less flexibility for interest rate cut in comparison to other moments in which the rate cut cycles were initiated.

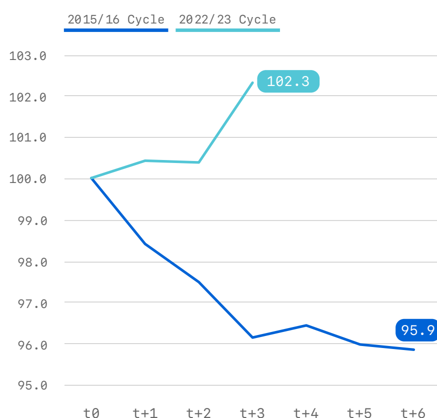
%

Desviations from target (in p.p.)	JAN/09	AUG/11	OCT/16	CURRENT
Implicit 1 year ahead	-0.5	1.6	1.4	0.6
Implicit 2 years ahead	-0.4	1.5	0.8	1.5
Implicit 5 years ahead	0.1	1.3	0.7	2.3
Implicit 10 years ahead	0.5	1.4	0.9	2.6
Focus 12 mo. ahead	0.3	0.9	0.5	1.4
Focus 1 year ahead	0.0	0.7	0.5	1.0
Focus 2 years ahead	0.0	0.0	0.0	0.9
Core 3MMA SAAR	-1.0	2.2	0.7	2.3
Underlying services 3MMA SAAR	2.6	4.7	1.7	2.9
Selected indicators	**JAN/09**	**AGO/11**	**OUT/16**	**ATUAL**
GDP same year	-0.1%	4.0%	-3.3%	1.8%
GDP 1 year ahead	7.5%	1.9%	1.3%	1.3%
Unemployment	8.0%	7.3%	12.3%	8.2%
Caged *(Admitted and Laid Off workers)* 3MMA	-69.072	124.549	-103.183	182.865
12-month accumulated *Caged*	1.207.536	1.778.675	-1.519.087	1.894.784
Speacil purpose credit (% of total)	32.9%	38.8%	50.2%	40.9%
12-month credit growth	29.6%	19.2%	-1.9%	11.1%

Source: BCB, *IBGE* (Brazilian Institute of Geography and Statistics), Mar Asset Management

FIGURE 2:
During the 16 months in which the Selic was stable before Ilan's cut cycle, GDP shrank 4% and opened a great economic gap.

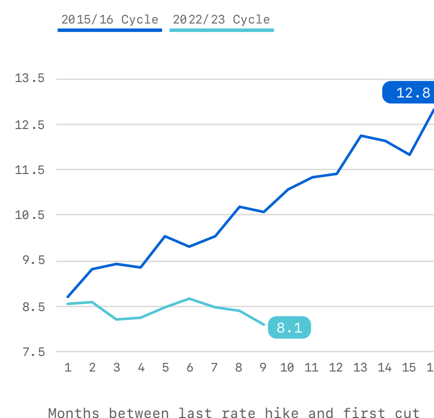
Index, GDP, High rate cycle's end trimester = 100



Source: *IBGE*, Mar Asset Management

FIGURE 3:
The unempployment rate rose more than 4 p.p. and was way above the NAIRU. The job market was not pressuring inflation.

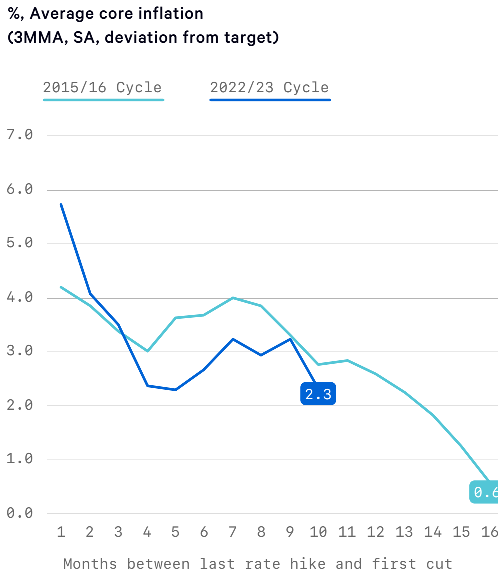
%, Unemployment rate, monthly and seasonally adjusted



Source: *IBGE*, Mar Asset Management

FIGURE 4:
The cut cycle only started when core inflation showed a clear trend towards the target...

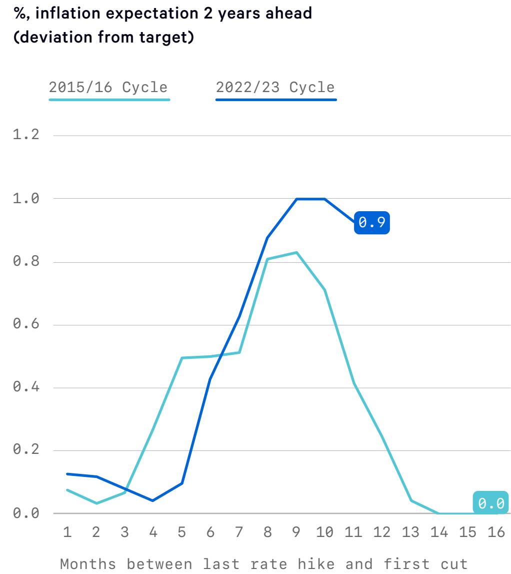
%, Average core inflation
(3MMA, SA, deviation from target)



Source: BCB, *IBGE*, Mar Asset Management

FIGURE 5:
...and medium-term inflation expectations were anchored.

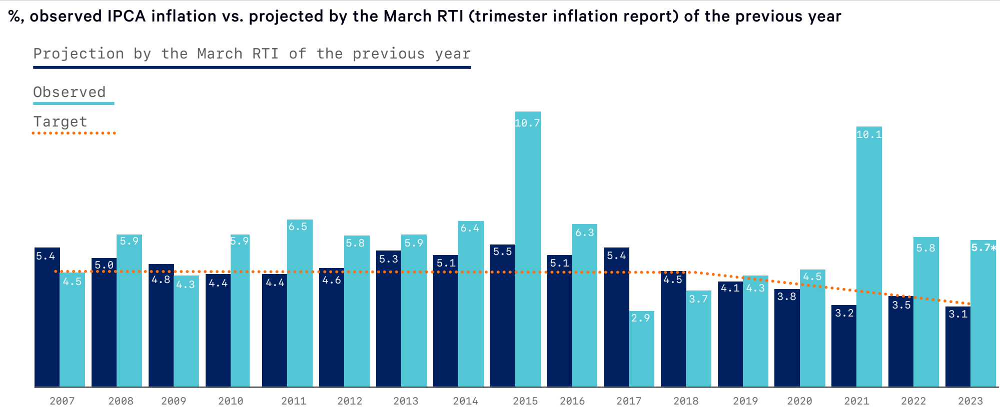
%, inflation expectation 2 years ahead
(deviation from target)



Source: BCB, *IBGE*, Mar Asset Management

FIGURE 6:
Central Bank models understimated the medium-term IPCA inflation in almost every year.

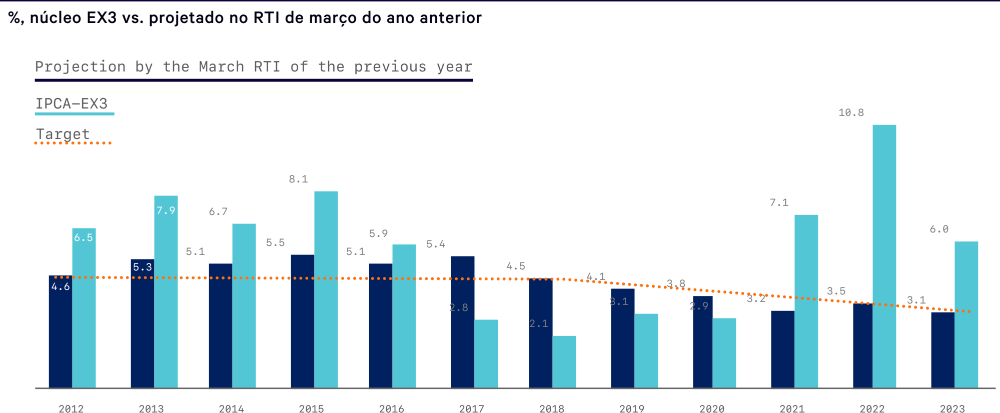
%, observed IPCA inflation vs. projected by the March RTI (trimester inflation report) of the previous year



Source: BCB, *IBGE*, Mar Asset Management

FIGURE 7:
O mesmo é válido quando consideramos os núcleos de inflação IPCA.

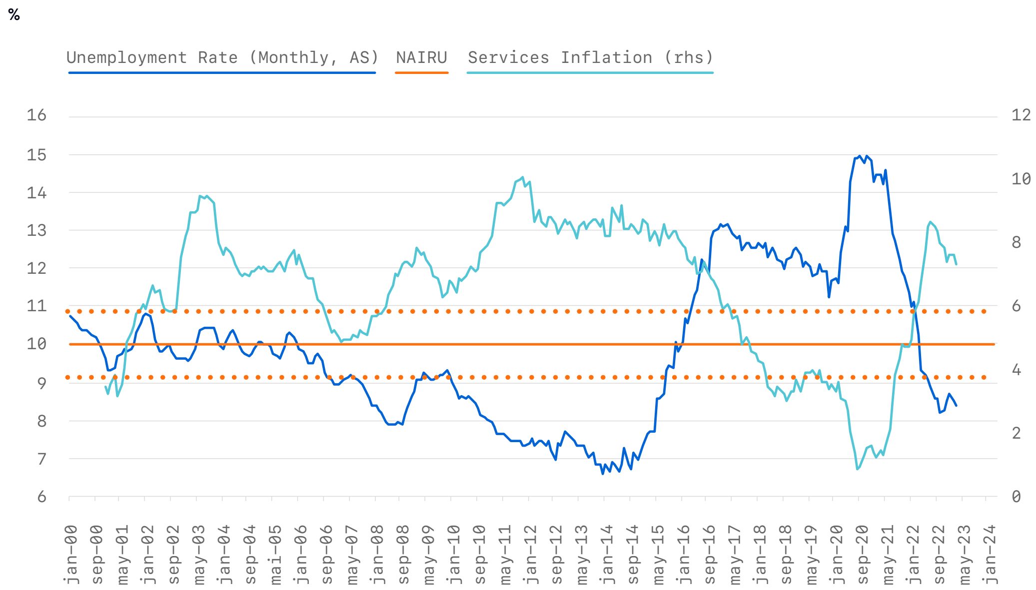
%, núcleo EX3 vs. projetado no RTI de março do ano anterior



Source: BCB, *IBGE*, Mar Asset Management

Phillips Curve

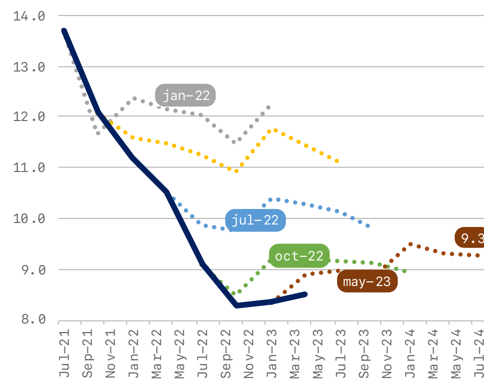
FIGURE 8:
An unemployment rate well below the NAIRU and very high services inflation do not prescribe monetary tightening reduction.



Source: *IBGE*, Mar Asset Management

FIGURE 9:
The market overestimated the unemployment rate for most of this economic cycle.

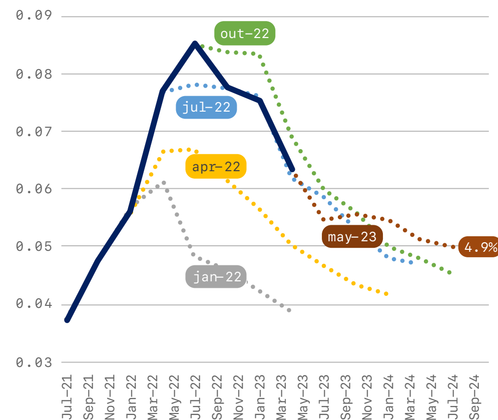
Unemployment rate: Real vs Projected by Focus
(%, 3MMA, NSA)



Source: *IBGE*, Mar Asset Management

FIGURE 10:
After consecutive surprising upward trends from services inflation, this group has shown a more benign dynamics. Sustainable?

Services inflation: Real vs. Projected by Focus
(%, 12-mo. accumulation)

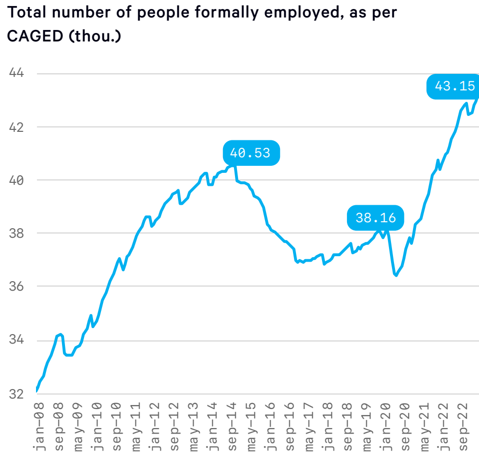


Source: *IBGE*, Mar Asset Management

Economic Activity

FIGURE 11:
The employed population population increased again in recent months, despite monetary policy still tight. How far will this movement go?

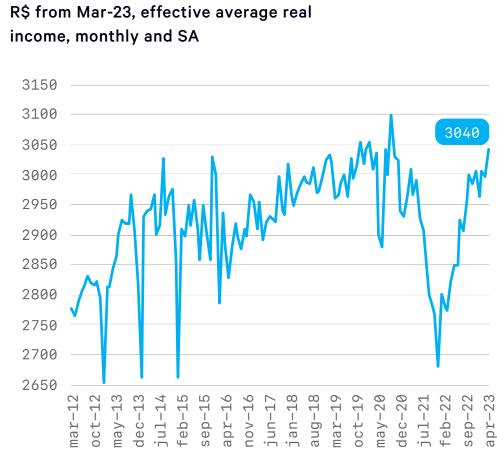
Total number of people formally employed, as per CAGED (thou.)



Source: Ministry of Labor and Employment Mar Asset Management

FIGURE 12:
Inflation reduction and tight job market led to a full recovery of real wage's value.

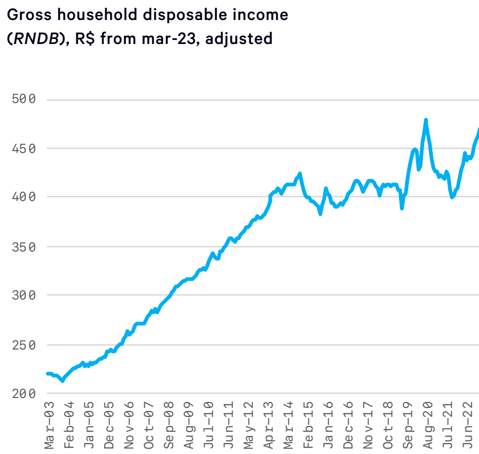
R$ from Mar-23, effective average real income, monthly and SA



Source: *IBGE*, Mar Asset Management

FIGURE 13:
The job market's recovery and cash transfers led to a strong increase of the National Household Income, which tends to support consumption throughout 2023.

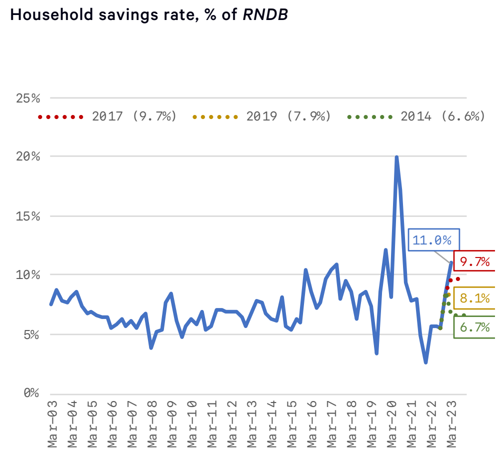
Gross household disposable income (*RNDB*), R$ from mar-23, adjusted



Source: BCB, Mar Asset Management

FIGURE 14:
This strong income increase has not totally turned into more consumption yet – our savings rate proxy suggests it is in the highest level in the last 20 years ex-pandemic.

Household savings rate, % of *RNDB*



Source: BCB, *IBGE*, Mar Asset Management

Companies

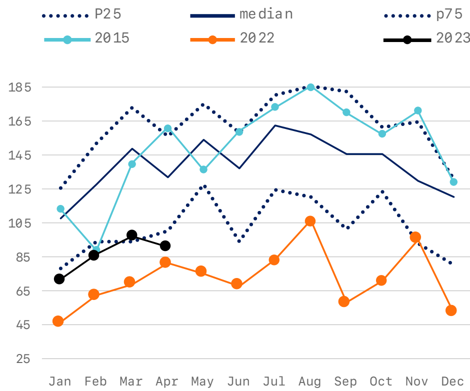
FIGURE 15:
There is no revenue contraction among publicly-traded companies, further atesting to a scenario with strong activity

Sales indicators: 1Q22 vs 1Q23	R$ mm 1Q22	R$ mm 1Q23	Nominal ΔYoY	R$ mm LTM
Samples Total	**157,372**	**183,594**	**16.7%**	**745,762**
Supermarkets	**42,596**	**47,421**	**11.3%**	**194,653**
Carrefour | Gross Revenue - ex Grupo BIG (Reported)	20,755	22,426	8.1%	96,507
Assaí | Gross Revenue - ex Extra (Adjustment MAR)	12,498	13,567	8.6%	53,080
Grupo Mateus | Gross Revenue (SSS to clean conversions BIG)	5,172	6,592	11.3%	25,949
Grupo Pão de Açúcar | Gross Revenue - ex Extra Hiper (Reported)	4,171	4,836	15.9%	19,117
E-commerce	**59,256**	**69,927**	**18.0%**	**280,447**
Mercado Livre |GMV - Brazil	20,702	26,499	28.0%	105,847
VTEX |GMV - Total (YoY FXN)	13,757	16,929	20.6%	68,360
Magazine Luiza | GMV - Total	14,124	15,548	10.1%	61,585
Via Varejo | GMV - Total	10,673	10,951	2.6%	44,656
Retail	**22,871**	**26,180**	**14.5%**	**114,258**
Ambev | Net Revenue - Brazil	9,598	11,047	15.1%	44,084
Renner |Gross Revenue - Products Sales	3,070	3,164	3.1%	16,054
Natura & Co | Gross Revenue - Brazil (Estimation MAR)	2,152	2,688	24.9%	12,500
Guararapes | Gross Revenue - Products	1,594	1,655	3.8%	8,173
Grupo SBF | Gross Revenue - Total	1,633	1,850	13.3%	8,073
Grupo Soma | Gross Revenue - Total	1,174	1,393	18.7%	5,869
Arezzo & Co | Gross Revenue - Domestic market	917	1,169	27.4%	4,932
Petz | Gross Revenue - Total	747	913	22.3%	3,533
Alpargatas | Net Revenue - Havaianas Brazil	566	575	1.6%	2,922
Vivara | Gross Revenue - Total	509	609	19.8%	2,839
Vulcabrás | Gross Revenue - Domestic market	482	621	28.9%	2,834
Grendene | Gross Revenue - Domestic market	430	495	15.2%	2,445
Pharma	**11,763**	**13,841**	**17.7%**	**54,878**
Raia Drogasil | Gross Revenue - Total	6,972	8,479	21.6%	32,457
Pague Menos | Gross Revenue - ex Extra Farma	2,112	2,316	9.7%	9,116
Hypera | Gross Revenue - Total	1,709	1,940	13.5%	8,889
Panvel | Gross Revenue - Total	969	1,106	14.1%	4,416
Shopping Malls (*)	**12,280**	**14,283**	**16.3%**	**56,784**
Multiplan | Total Sales from Stores	3,975	4,611	16.0%	20,652
Aliansce | Total Sales from Stores - Pro Forma	4,964	5,768	16.2%	18,604
Iguatemi | Total Sales from Stores	3,341	3,904	16.8%	17,527
Airlines	**5,855**	**8,706**	**48.7%**	**31,600**
Azul | Net Revenue - Passengers Transportation	2,843	4,170	46.7%	15,922
GOL | Net Revenue - Passengers Transportation	3,012	4,537	50.6%	15,678
Restaurantes	**2,752**	**3,237**	**17.6%**	**13,142**
Arcos Dorados | Net Revenue - Brazil (YoY CC)	1,581	1,918	19.2%	7,678
ZAMP | Gross Revenue - Sales	867	963	11.1%	4,042
IMC | Net Revenue - Brazil	304	356	17.0%	1,423

(*) there is an overlap revenue from Retail
Source: Mar Asset Management

FIGURE 16:
Depsite showing an increase in relation to last year, the number of companies under court-supervised financial reorganization is still quite low vs. history.

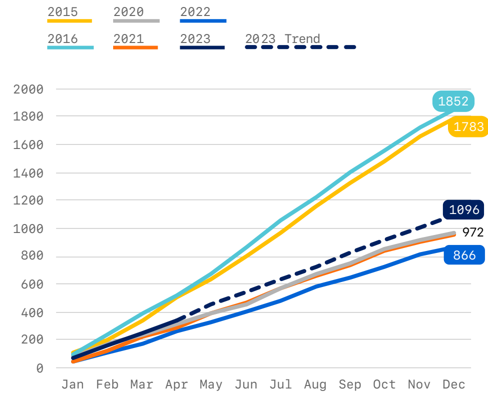
# of filings for court reognization by mo. – data from 2009 to 2023.



Source *Serasa* (credit rating agency), Mar Asset Management

FIGURE 17:
The total of companies under reorganization is well below the levels seen in periods of recession and much closer to the levels seen in recent years.

# of filings for court reorganization

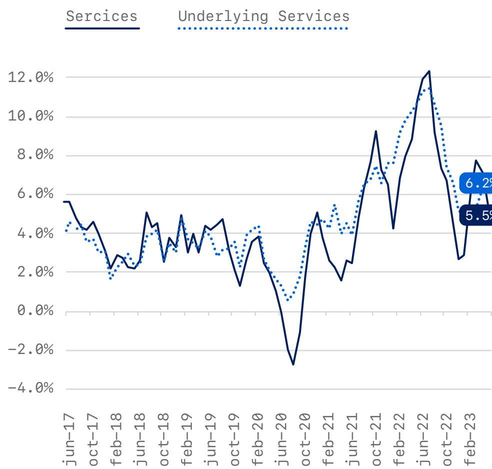


Source: *Serasa*, Mar Asset Management

Inflation

FIGURE 18:
After falling several months in a row, services inflation went back up early 2023. Given its weight and degree of inertia, the current level is incompatible with an *IPCA* sustainably within the target.

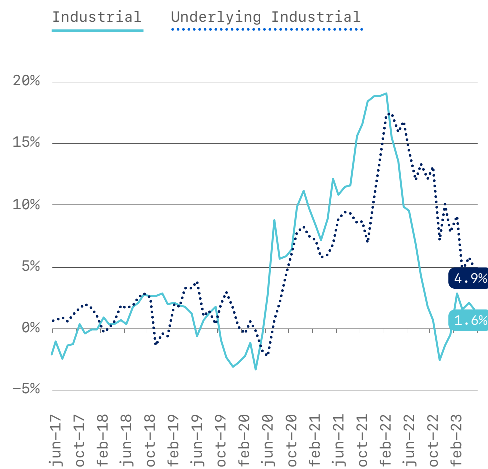
%, 3MMA , SAAR



Source: *IBGE*, Mar Asset Management

FIGURE 19:
The exchange rate's good behavior and the normalization of global chains pushed the inflation of goods back to very low levels.

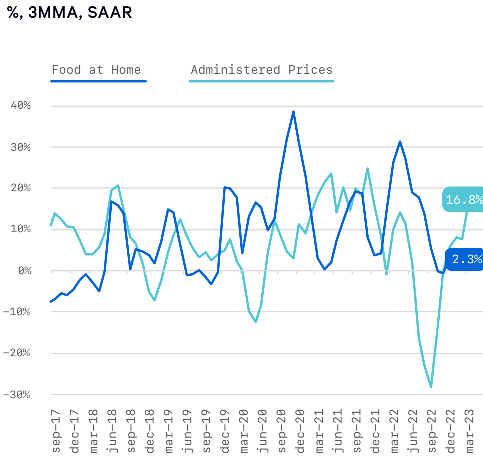
%, 3MMA, SAAR



Source: *IBGE*, Mar Asset Management

FIGURE 20:
Food items inflation has greatly contributed to slowing down the IPCA these last months, partly, due to the generous harvest yield.

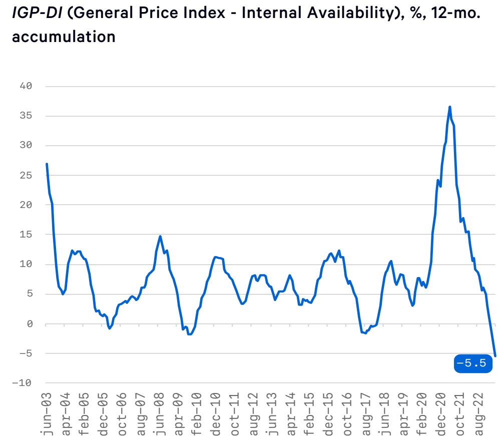
%, 3MMA, SAAR



Source: *Receita Federal* (Brazilian Revenue Service), Mar Asset Management

FIGURE 21:
Inflation to producers is still surprisingly on a strong downward trend. This *IGPs* dynamics is a bear market risk for the short-term IPCA inflation.

IGP-DI (General Price Index - Internal Availability), %, 12-mo. accumulation

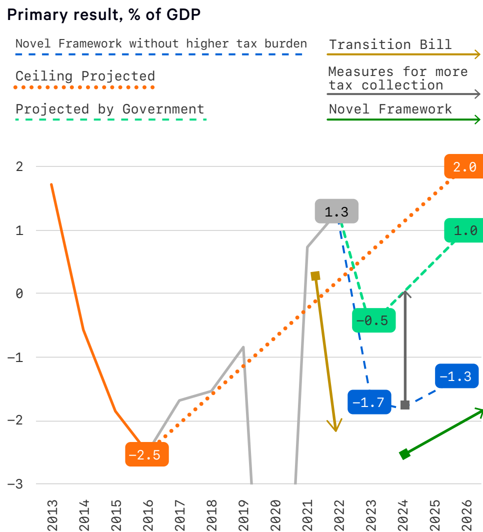


Source: *FGV* (Getúlio Vargas Foundation), Mar Asset Management

Fiscal

FIGURE 22:
The Novel Framework does not suffice to revert the negative impact from the Transition Bill. A positive primary result depends on more tax collection.

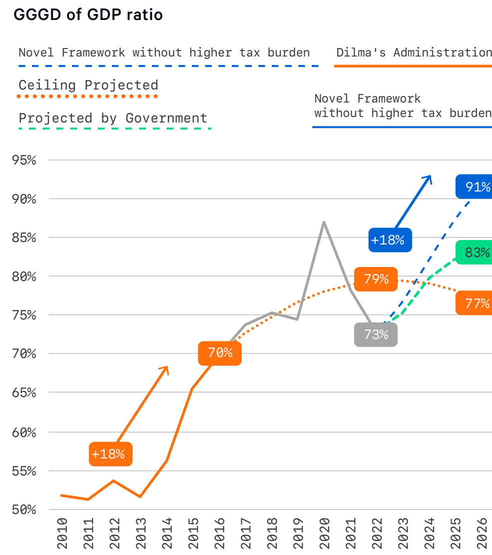
Primary result, % of GDP



Source: BCB, Mar Asset Management

FIGURE 23:
The Novel Framework itself will lead to an increase of GGGD by 18pp of GDP - the same as with Dilma - if not compensated by more revenue.

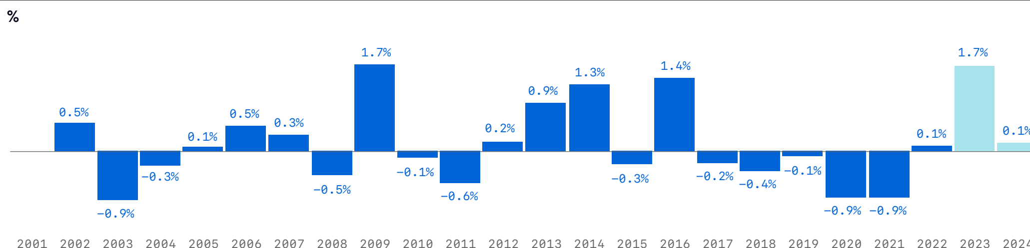
GGGD of GDP ratio



Source: BCB, Mar Asset Management

FIGURE 24:
The structural fiscal drive for 2023 will the greatest since 2009 and may not be fully counterbalanced by monetary tightening.

%



Source: BCB, Mar Asset Management

"In big wave surfing, one does not paddle in the first of the set".

mar asset management

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