Newsletter: November 2022

Searching for the Gregorian horizon

mar asset management

The year 2022 is ending, and the reflection on how 2023 will unfold makes its way into the spotlight of economic assessments. The onset of every year never ceases to intrigue us as we write up and review our personal and professional scenarios.

Ever since Pope Gregory XIII, on February 24, 1582, enforced the Gregorian calendar over its Julian counterpart, we have seen December 31 as a beacon, signaling the end and start of a 365-day cycle.

Many regard the end/start of the year as something more than a mere Western society-derived norm to organize our schedule better, particularly our tax payments. It is often regarded as a potential game changer for markets and prices.

Even so, as we greatly admire and respect the formalities and cultural behavior, we also share our Gregorian reflection.

This year seems special for such a practice.

Where we came from and where we are

In the last three years, investment decisions at Mar Asset revolved around a focal point. The Covid-19 pandemic and its economic consequences shaped the dynamics of global economies and financial asset prices to a great extent.

With its biblical proportion, the pandemic was the world's main character. Our portfolio analysis's most critical backdrop was understanding its ins and outs and side effects.

As our investors and readers already know, we build our portfolio from the bottom up, be they macro or micro ideas. The top-down analysis serves to inform the portfolio suitability for risk appetite.

Nevertheless, thinking about the pandemic gave birth to interesting ideas and allocations. Notably, the stances we took in favor of interest rate hikes, starting with the long end of Brazil's yield curve and then migrating to the short end of Chile's curve, followed by the same stance on the short and long segments of the US curve.

Our stances on interest rates were essentially a beaten path strategy. We observed its onset within emerging economies, with faster rate increases due to their lesser central bank credibility. It was later replicated by the more credible monetary authorities from developed nations, who could afford to observe how their economy evolved for longer before taking action. Therefore, they were better informed about inflationary diagnostics.

We have thoroughly described this process in two newsletters[1] made public this year.

Currently, the market is pricing a Fed Funds terminal rate for the current cycle close to 5%. Even though we believe its risk is closer to 6% than 5%, we understand the last global tightening cycle, led by the Fed, is coming to an end.

As the "world's central bank", the Fed will ultimately set in motion an economic slowdown and victory over inflation. This win will cost a great deal, the magnitude of which is still unclear today.

The primary and most likely cost will be a strong contraction of US household consumption, the key driving force to the world's largest economy and the principal source of the current inflationary trend. Because of its strength, household consumption has made the Fed's job all the more complex and potentially more expensive.

1 Waves and prices (June 2022) and Prices and Curves (August 2022)

We have always nurtured great confidence that inflation control should be done through monetary tightening, with its main instrument being policy rate increases.

As we close in on the tightening cycle's end, our last "certainty" is stripped away, and we are only left with the doubt on which, and how intense, this battle's side effects will be.

At first, we had foreseen that by the tightening cycle's end, we should move into a wave of monetary easing cycles in numerous economies, especially those that promptly reacted throughout the process.

We currently have doubts about the next step.

The interest rate cuts cycle will indeed happen, for tight monetary policies will have to be reverted at some point. The current challenge, though, is pinpointing when.

This makes the road ahead - 2023, rather uncertain for allocating capital.

A draft and not a drawing for the 2023 scenario

Our rough draft for 2023 is of a high-inflation environment, demanding longer high interest rates, and the start of an effective economic slowdown, mainly by reducing household consumption.

We should live with stagflation for a while.

We predict falling consumption amid persistently high interest and inflation rates, but with relatively expensive financial assets, in virtue of the investors' quest for the turning point.

At first glance, this mix makes up a very difficult scenario for allocating capital in risk in recent years.

This transition into a period of effective and structural interest rates cuts poses several risks. The greatest one is the anxiety in taking a stance on risk assets hastily due to a transition that might take longer than expected.

We should avoid falling into the FOMO (fear of missing out) trap.

Regarding the macro class, the risk is as clear as day. Betting on interest rate cuts that may not ultimately occur, or at least is not within the expected time frame.

Regarding stocks, as we see it, the market had already been preparing for an interest rates cut scenario. This scenario would reprice stocks multiples upward in light of decreasing capital cost and boosting demand, improving estimates for companies' income.

On the way there, however, we will be trekking in an environment with (i) high interest rates, which press down on multiples and slow income prognostic; (ii) doubt on the US neutral interest rate, which anchors global capital cost; (iii) high inflation, which tends to compress profit margins across the board.

Such an environment does not favor stocks and calls for more prudence when investing in a company. As Warren Buffet would say: interest acts on financial valuations the way gravity acts on matter: The higher the rate, the greater the downward pull.

What about Brazil?

Raising the level of uncertainty ahead, specifically for Brazil, this year will see Bolsonaro's 4-year term to an end.

Every change in government raises doubts. However, this electoral period was surprisingly the least volatile of all. So says the market.

This overly calm market amid the different electoral results was such that it concerned us even before voting began.

We believed that neither candidate would radically change economic policies, but, all the while, we considered there were essential differences between the two.

The level of conviction adopted by the markets about the candidates' moderation put us on alert and prompted us to build defense stances at reasonable prices.

The biggest surprise during the electoral process

During the electoral process, we were caught off guard by a highly specific topic: then-candidate Lula's decision not to inform his future minister of finance.

During the run-off voting dispute, such a statement would be of utmost importance for Lula to capitalize on moderate voters that had not yet made a final voting decision, and the lack thereof would pose a risk to his victory.

Confronted with this issue, we asked ourselves why a seasoned and pragmatic politician, such as Lula, would risk losing the election without pulling the moderate finance minister "card up the sleeve," in case that was his ultimate intention.

Suppose Lula was playing the economically moderate card, in tune with PSDB (Brazilian Social-Democracy Party) economists. Why not announce his minister during the run-off election campaign and "bring it home"?

We were anxiously looking forward to the statement, which never did come, leaving us in the dark about how to interpret this matter.

Is it the case that, nowadays, Lula is less pragmatic than we believed? Less moderate? Less inclined to come closer to a market economy than it seemed at first sight?

These types of questions do not offer easy answers. However, so far, our take, is a yes, to all of them.

We regard Lula's refusal to choose a minister as a move towards his independence from the markets. As if he did not need to answer to market expectations to win the election, thus he would be "free to answer to the people's expectations."

The challenge herein is understanding whether such a strategy is compatible with what voters demanded in these elections.

A new ruler's legitimacy depends significantly on the clarity with which they implement the social demands that led them to victory.

However, two very distinct government platforms and a result that we see as a near tie represent per se the lack of unity and clarity from the ballots.

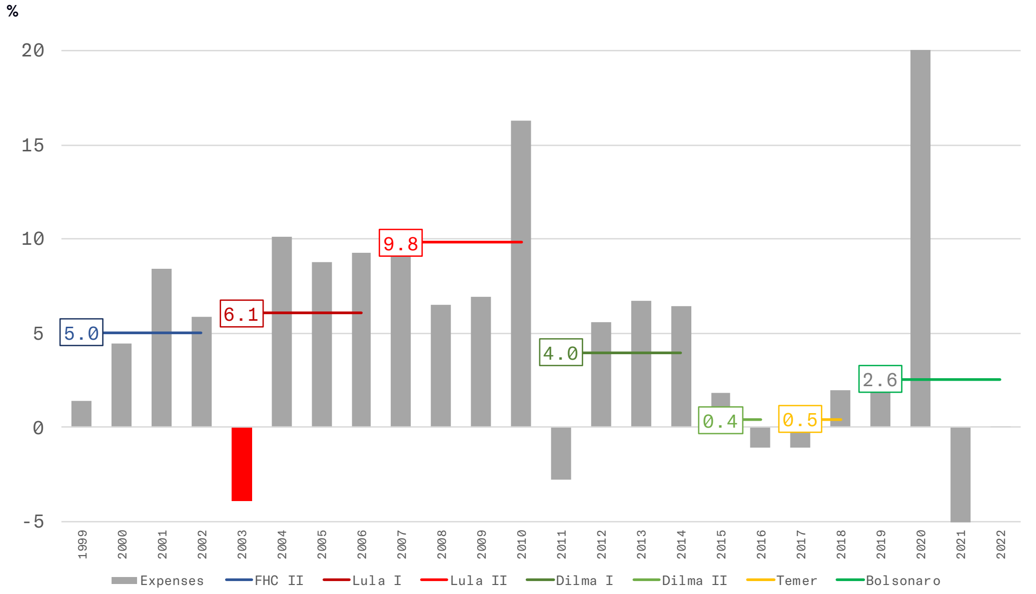
We have a winning candidate who, as we see it, put himself at great risk during the campaign to win the freedom of action about the market and the economic elite.

Lula seems to have his own interpretation of the ballot's messages, which hardly reflects the aspirations of 50% of the population, but still presents clear ideas on what he intends to do. Notedly, about increased government spending.

Our "Lula from Fiscal Policy Perspective" study argued that a PT (Workers' Party) administration with a 2% real growth government spending, on average, would be the most conservative in history.

It would mean an administration with 1/3 of the spending increase rhythm observed in Lula I and II and half of what was seen in Dilma I.

Figure 1: Real growth of primary expenses



Source: Tesouro Nacional (National Treasury of Brazil), Mar Asset Management

As per PT's understanding, even with a fiscally conservative administration, it would not be enough for debt/GDP stabilization.

Not unless tax hikes make up for spending.

Political/social-derived risk

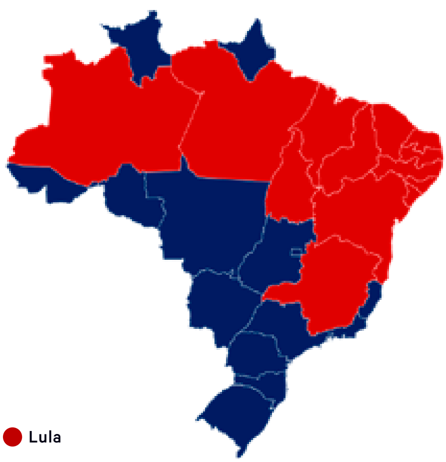
This is what concerns us the most about the political/social environment for the years to come in Brazil.

As previously mentioned, the way to raise spending without provoking debt to unbalance is by increasing taxes. A little over 15 years ago, since the CPMF (Temporary Financial Transactions Contribution [to Health]) failed to come back under Lula's term, the "tax hike" topic has become taboo in Brasília, given society's perception of an excessive tax burden.

Everyone knows the election result, besides a historically close match, was also very geographically distinct. Bolsonaro's electoral upper hand in the Southeast, South, and Center-West did not suffice to even out former president Lula's advantage in the Northeast.

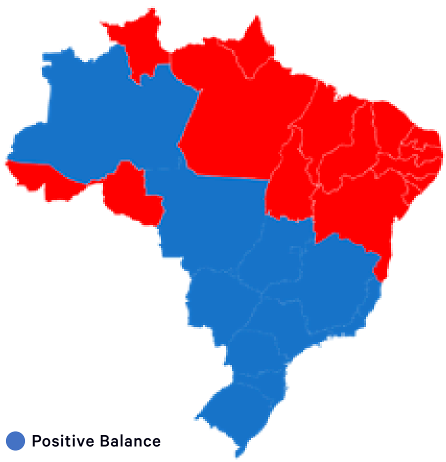
Besides being highly unpopular, tax hikes would be a more significant burden in Bolsonaro country, while allocation distribution beneficiaries are more densely concentrated in Lula-backing regions.

Figure 2: Geography of run-off presidential voting



Source: TSE (Superior Electoral Court), Mar Asset Management

Figure 3: States according to the balance of tax paid minus transfers received from the Federal Government



Source: Receita Federal (Revenue Service of Brazil), CGU (Office of the Comptroller General), Mar Asset Management

With a highly divisive electoral grid, this geographical perspective in tax collection increase and wealth distribution might well be the seeds for a social and ideological conflict to be fought in public debate in and out of Congress. There will be pressure on elected officials in the Southeast/South/Center-West against the federal government's policy, further deepening society's division.

Government policy disregarding a large portion of the population may worsen sharply and swiftly presidential popularity at the very start of his term. This would naturally set more uncertainty and difficulty on the Executive branch's table in dealing with other branches of government.

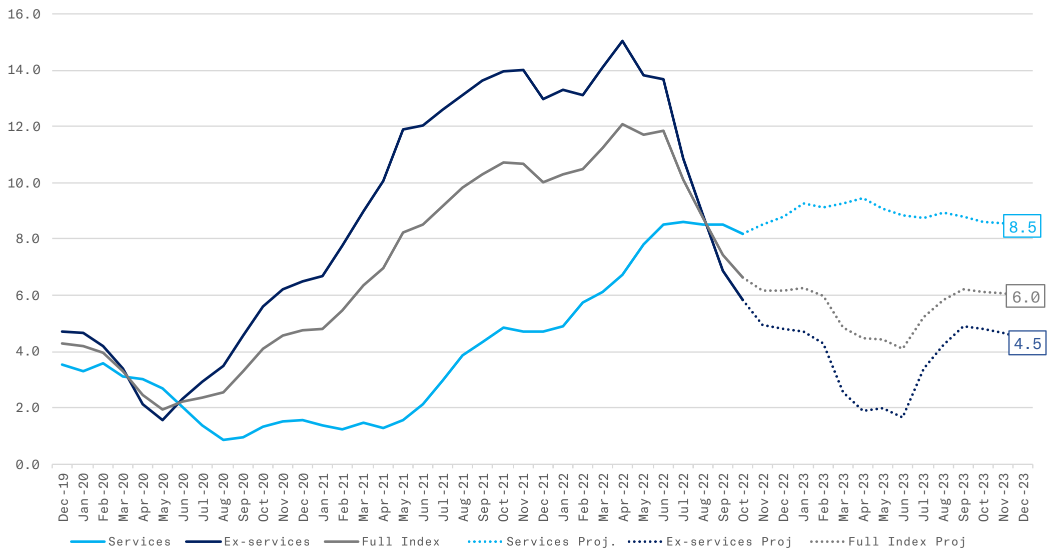
This scenario will make raising taxes harder to balance the fiscal budget, considering the spending growth that seems to have been undertaken. The government will face the dilemma between giving up on this central agenda without extra tax collection and keeping with increased public spending, regardless of fiscal imbalance.

Brazil Inflation

Adding to the relevant fiscal policy challenge, we will march into 2023 with a still very high level of inflation. We gather that the inflationary scenario is much less clear than market consensus perceives.

Graph 4: Projection for services and ex-services IPCA* inflation

%, accumulated over 12 months



Source: IBGE (Brazilian Institute of Geography and Statistics), Mar Asset Management
*** IPCA: Extended National Consumer Price Index**

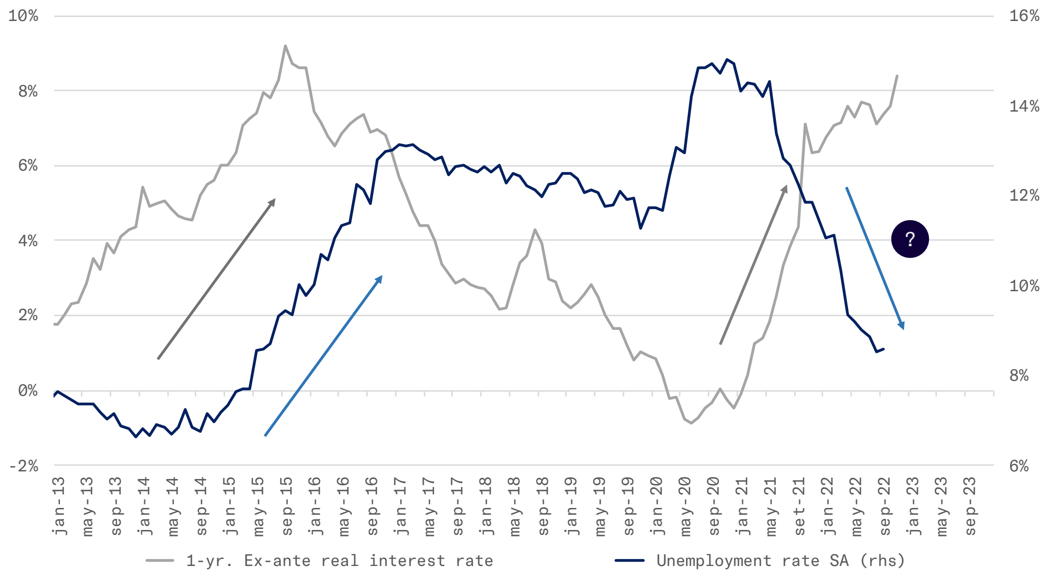
As described in full in our studies published in September[2], we realized it is a great challenge for the BCB (Brazilian Central Bank) to bring inflation back to its target.

Though the BCB was quick and fierce to act in the interest rate boost cycle, the GDP gap is trekking down in the opposite direction than expected from tight monetary policy. More than 12 months later, with 1-year ex-ante real interest rates above 6.0%, the unemployment rate keeps falling, and the economy keeps adding around 200 thousand new jobs every month.

2 [Interest Rate in Brazil – first to go up, first to come down? (September, 2022)]

Graph 5: 1-yr. ex-ante real interest rate and the unemployment rate

%, % a yr.



Source: Bloomberg, IBGE, Mar Asset Management

It is unlikely that services inflation, currently close to 8.5%, will converge to the target in the short term, given that the output gap keeps decreasing instead of increasing.

As we see, the much hoped-for output gap increase will not occur in the medium term either. We have a positive expectation for GDP next year, which will be propelled by aggregate demand. This is so whether by household spending growth via real wage bill increase, by real minimum wage increase, by civil servants' wage increase, and by government spending growth. In this scenario, services inflation tends to remain high.

The Market as an agent of discipline?

Should a finance minister be chosen based on political criteria, the government will be deprived of a natural defender of tighter fiscal policy. The financial market will then be responsible for "safeguarding" fiscal accountability, pressuring market prices every time the government presents economic policy decisions that risk fiscal balance.

A market stressed by fiscal and economic run-ins would generate intense volatility, resulting in equity prices with premiums that pay for this volatility and risk.

As is the case with a seasoned politician like Lula, our main scenario is that the government takes a step back in reaction to the market's red flags. However, this political back and forth always carry the risk of setbacks.

The main setback would be a worsening perception of public finances within an inflationary environment, giving birth to the debate on fiscal dominance.

Fiscal dominance represents the incapability of using the interest rate to tackle inflation, given that the interest rate increase paid over public debt makes it unsustainable, simultaneously unanchoring fiscal and inflationary expectations.

This scenario would produce extreme mistrust and pessimism regarding economic policy, which we witnessed for a short period on the run-up to President Dilma Rousseff's 2015 impeachment.

The developed world is now adopting the classic Brazilian antagonism between loose fiscal and tight monetary policy

Nowadays, we look to a possible world with recessions together with high interest rates, due to the difficulty in bringing down inflation to its target. The long inflationary period is already producing some contamination of prices in major economies.

The outlook for Brazil, regarding fiscal spending to combat social inequality while the BCB tightens its grip on monetary conditions, will not be sui generis and limited to Terra Brasilis. It is part of a global phenomenon with a demand for greater fiscal activism, which will have to be compensated by more strict monetary policies.

Together with a reshoring movement and ESG, we foresee a world with more significant inflationary pressure, compatible with structurally higher neutral interest rates worldwide.

The "Brazilian" topics – interest rates, high and permanent inflation, and additional fiscal spending stress – will no longer be solely our thing.

A scenario with a structurally higher international cost of money, with difficulty within the global deflating process, plus a local scenario filled with transitions and uncertainties conforms to an arid environment for our search for good investment opportunities.

Patience to find a horizon.

All the scenario description carried out in the last few pages takes us back to the original point. Our end-of-year reflection shows that we must be aware of the troubles we will face as capital allocators on this path up the road.

The combination of disturbed external and internal scenarios puts us at a level of uncertainty we have not experienced in our portfolio since the pandemic crisis.

Because it has been hard to read the market, we will have little comfort regarding relevant risks in our portfolio for the next quarters. Thus, we shall study intensely and double down on attention to comprehend the mainstream trend for future prices.

Focus, dedication, and even more attention should be harmonized with a good dose of patience, which shall be vital for us to sail through next year. In transitioning environments, which is the future right around the corner, it is essential to be cautious so as not to be over our heads.

In turbulent waters, where sea and sky blend, our view of the horizon becomes murky, and the capability to look outwards and see the waves rolling towards the coast becomes temporarily compromised.

The surfer ought to have patience and caution in choosing waves, waiting for the horizon to show itself once again.

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