mar asset management

letter: September, 2023

Fasten your seatbelts, are we landing...?

In the wake of an unparalleled global economic downturn triggered by the Covid-19 pandemic, governments worldwide took extraordinary and unprecedented measures. They swiftly implemented aggressive monetary and fiscal stimulus packages on an unprecedented scale, aiming to mitigate the social fallout of the impending recession. Then, they subsequently faced the challenge of reacting in a coordinated way to contain inflation, which emerged as the main adverse side effect of the – successful but sometimes excessive – stimulatory policies.

We are experiencing the moment of landing of these economies, in which it is necessary to curb domestic demand to control inflation.

One of the biggest anti-inflationary economic policy challenges is the belief that this process can be carried out without a social downturn.

Throughout time, economic policies have evolved with the purpose of minimizing social impacts from economic fluctuation. However, some degree of downturn, manifested by a widening output gap or increased unemployment, is inevitable while adjusting the cycle.

Resistance to economic slowdown by government leaders has always represented the greatest structural risk to disinflation strategies, as the political calendar often diverts from economic cycles.

Although politicians seek to stimulate their economies and improve the population's well-being, the policies adopted must consider the economic cycle stage to balance short- and long-term costs and benefits.

In order to manage this process, many countries chose to grant central banks independence. This approach aims to ensure that monetary policies, aligned with economic cycles and focused on optimizing medium and long-term results, are not undermined by the short-term goals inherent to political cycles.

The current global economy settling-down stage signals the “beginning of the end” of the great synchronization that characterized the years since 2020. In this scenario, each economy now chooses its own path towards settling down.

The debate on how the adjustment process would take place began in 2021 and was initially limited to the “soft” and “hard landing” dichotomy, but it evolved into a more complex discussion, analyzed later in this paper. Because there is some chance of US policymakers pulling off a soft landing, previously doubted due to its singularity, this has now become a target for central banks around the world.

The complex and delicate central banks’ role, which consists of controlling inflation (not seen in developed economies since the 1970s), has taken on yet another dimension: a somewhat implicit competition amongst monetary authorities to see who can reach the inflation target with the least cost.

When we refer to the "cost" related to inflation target convergence, we are considering the need for economic slowdown and an increase in unemployment to achieve such an objective (Sacrifice Rate).

We have been apprehensively watching the creeping complexity in monetary policy decision-making derived from this "competition".

This is especially relevant for central banks in emerging economies that have adopted an inflation target system. In this context, the quest for a lesser cost may sometimes neglect the monetary policy’s main and clear goal: inflation control.

The fundamental reason for inflationary control is the preservation of purchase power so that society can confidently save and make transactions in national currency.

Argentina is a striking example of negative effects arising from the loss of credibility in currency due to inflation. The lack of confidence in the Argentinian Peso has given birth to a scenario in which the leading presidential candidate's main bid is to "re-dollarize" the economy, as the sole option to regain monetary credibility and stimulate internal savings, but reminding us of their own traumatic experience in the 1990s.

Back to discussing the different kinds of economic landings, we currently see quite a variety in the American continent.

Chile

In the far South, Chile is attempting to fly down towards the runway's threshold in a classical approach. After implementing substantial monetary and fiscal stimulus, the policymakers responded in an orthodox fashion by simultaneously adopting tightening measures for both monetary and fiscal policy.

As a result, Chile has gained high credibility by demonstrating a firm commitment to inflation control. This approach has consolidated inflation expectations in line with the set target, enhancing the economic tightening measures and favoring the fulfillment of its objectives.

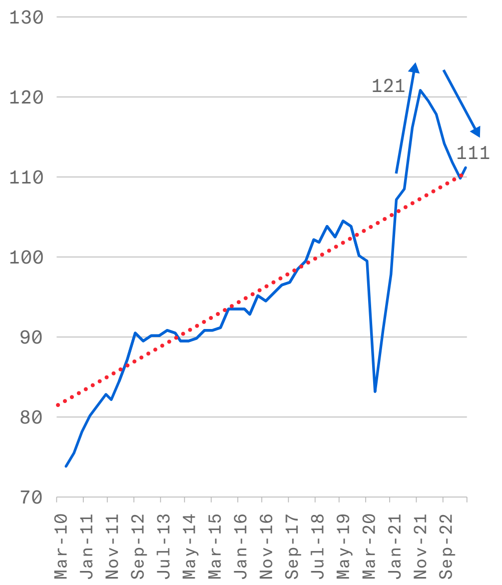
Chile is carrying out a textbook landing: the coordinated application of restrictive measures in the fiscal and monetary areas is leading to decreased internal demand and increased unemployment. This economic context gave rise to a gradual and consistent decrease in inflation.

We have coined the term "hard(ish) landing" because although it is not a hard landing per se, the policymakers did not hesitate when it came to sacrificing economic activity in order to achieve its prime objective: keeping inflation within the target.

It is possible to assert that Chile finds itself ahead of the curve in terms of settling down and effective normalization of its economy, treading a clear path after the economic trial post-pandemic period.

FIGURE 1:
Chile's domestic demand (Consumption + Investment)

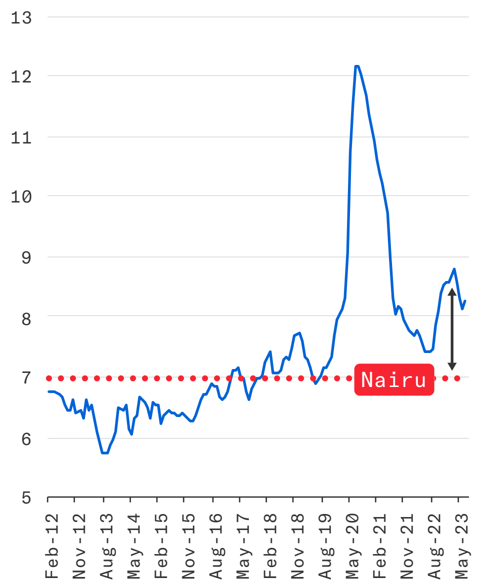
Index number, 4T19=100



Source: BCCh (Chilean Central Bank), Mar Asset Management

FIGURE 2:
Chile's unemployment rate

% of work force



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United States

In North America, the US is surprisingly on the way to something even better than a soft landing: the perfect landing!

Inflation, especially the group of services more sensitive to the economic cycle, is converging to the Federal Reserve's (Fed) target without any unemployment rate increase. On the contrary, the average GDP growth in the last four quarters was close to 2.5%, above what is considered to be the economy's potential.

It was widely discussed in markets and global economic fora if such a feat – Perfect Landing – would be possible. Not long ago, we were more skeptical[1]. However, inflation and wage data have forced us to reconsider.

1 See, for example, our letters "Waves and Prices" and "Prices and Curves", from June and August 2022, respectively (link).

Investigating the US case has revealed unique features in the "landing" process. Despite being significantly on the rise and above the most optimistic economists' expectations – including our own -, the unemployment rate remains at a stable level and very much like the pre-pandemic period. During this time, inflation expectations have been persistently in line with the Fed's set target. One of the aiding factors that may have played a considerable role in the process of the unemployment rate stabilization, despite growth surpassing the potential, is the increase in immigration. This foreign population increment by about 4 million people since 2021 made it possible to fill job vacancies without decreasing unemployment.

The combination of an economy that in the last decades showed structural inflation close to zero, anchored inflation expectations and an exceptional capacity to expand the supply of labor, has made it feasible to create jobs at a pace much greater than the state of equilibrium, without equal pressure on wages.

In the first months of 2023, we witnessed once again Payroll (net jobs index) consistently beat the consensus. However, the simultaneous increase in the workforce was vital to keep the unemployment rate from going under 3.5%.

Ever since mid-2022, on the other hand, we have observed a gradual, but consistent fall in wages. More recently, we have seen an inversion of the Payroll surprises, with numbers below market expectations and downward reviews of previous numbers, solidifying our confidence in the continuity of the labor market's rebalancing.

Thus, despite the economy having shown resilience, the labor market is slowly adjusting itself. The number of unfilled job openings, as a proportion of the workforce, which reached 7.3% in 2022, has consistently fallen in the past months, reaching 5.3% in July 2023. This adjustment in job supply and demand conditions is contributing to a continuous drop in services inflation and pointing towards a "perfect landing".

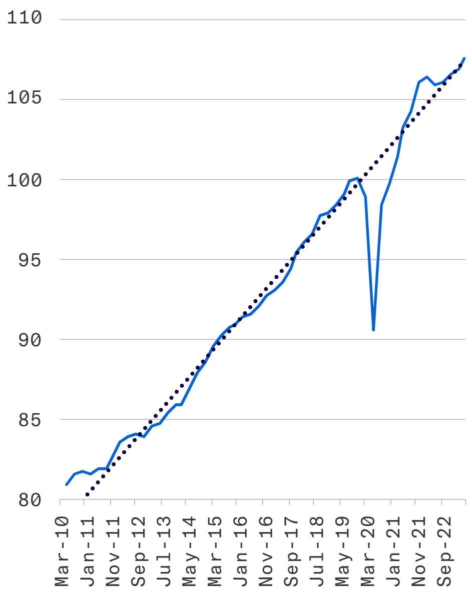
Looking ahead, we still regard economic slowdown as necessary, going back to potential levels of real growth between 1.5% and 2.0%. The main risk is the economy steadily growing at the current pace for the next quarters and pressuring wages once again.

In this case, the perfect landing would be aborted and the "touch-and-go" would scare passengers. Those who have lived on the Rio-São Paulo air bridge know how unpleasant a touch-and-go maneuver feels.

As Jerome Powell said, even amid the current unprecedented conditions and navigating monetary policy "by the stars under cloudy skies", the Fed does not seem to be facing heavy winds, but rather a breeze, to be monitored before touching down.

FIGURE 3:
US domestic demand (Consumption + Investment)

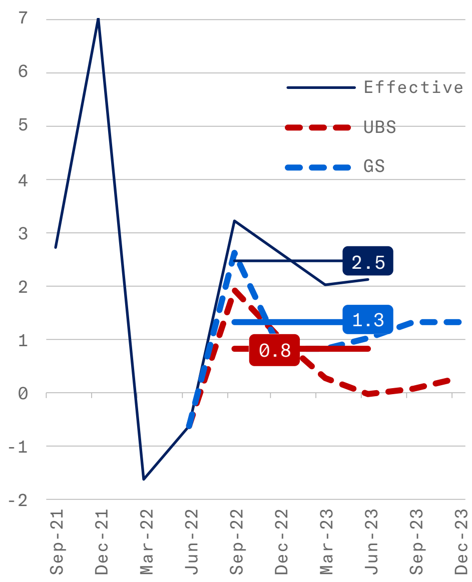
Index number, 4T19=100



Source: BEA, Mar Asset Management

FIGURE 4:
US quarterly GDP growth – effective vs. projected

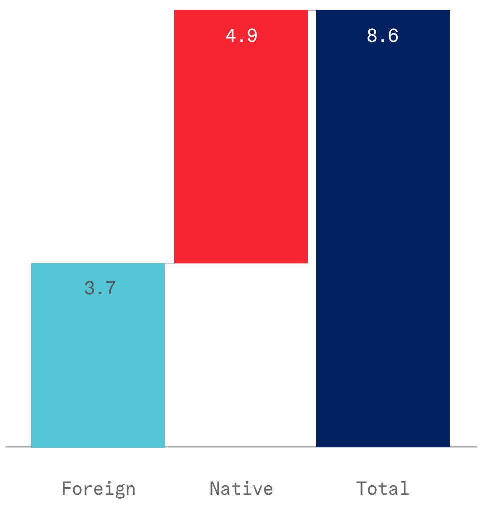
%, SAAR



Source: BEA, Goldman Sachs, UBS, Mar Asset Management

FIGURE 5:
Employed Population Growth in the last two years

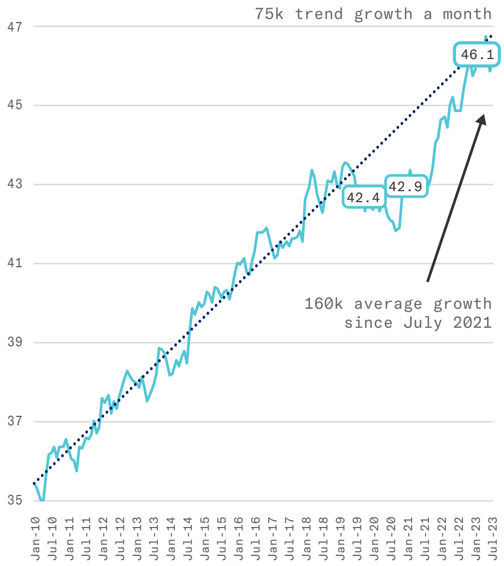
Millions, 3MMA, NSA



Source: BLS, Mar Asset Management

FIGURE 6:
Foreign-Born Working Age Population in the USA

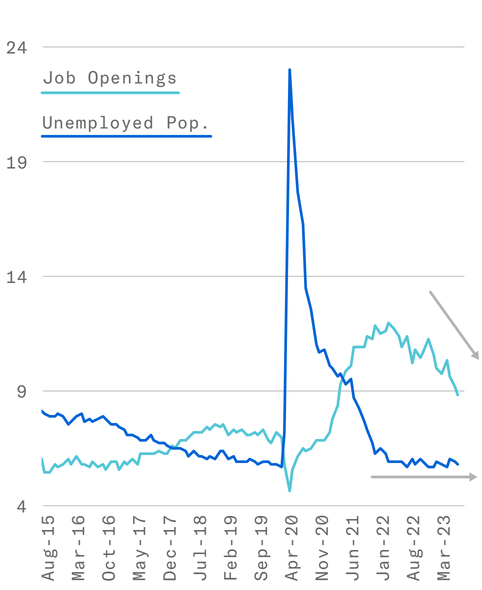
Millions



Source: LS, Mar Asset Management

FIGURE 7:
Number of unfilled job openings and total unemployed population

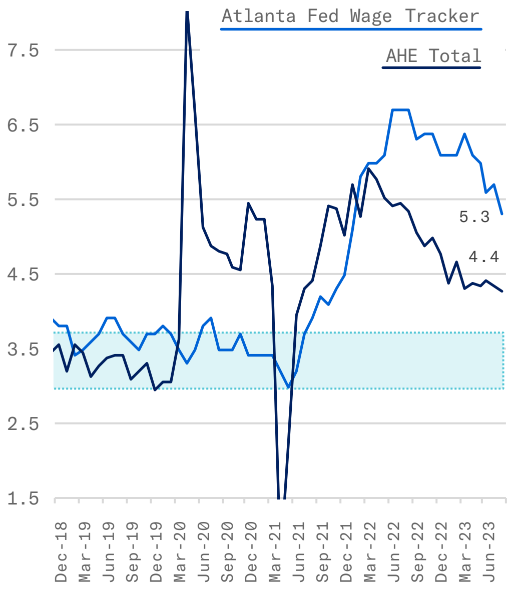
Millions



Source: BLS, Mar Asset Management

FIGURE 8:
Wage Inflation (%, yoy)

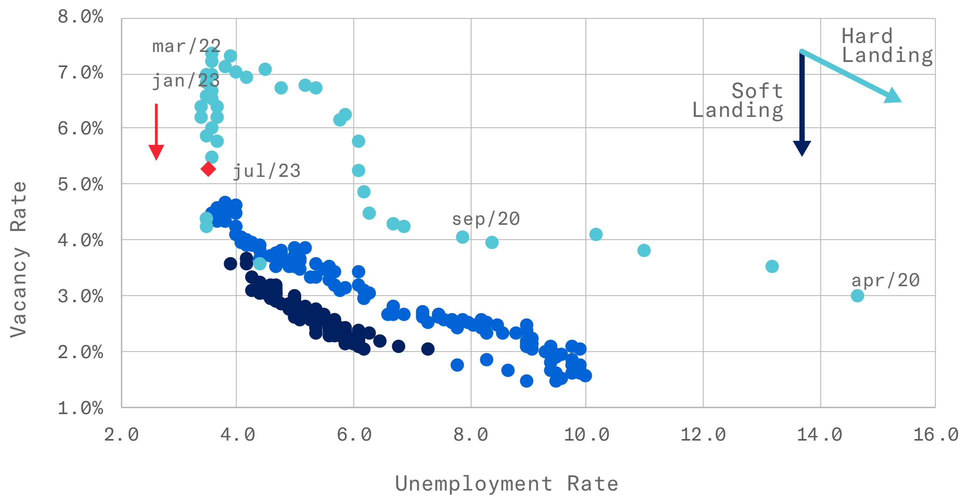
%, yoy



Source: BLS, Atlanta Fed, Mar Asset Management

FIGURE 9:
Beveridge Curve – job openings rate vs unemployment rate

%, of work force rate



Source: BLS, JOLTS, Mar Asset Management

Mexico

South of the border, we have the Mexican case. Despite not having implemented a significant fiscal stimulus program during the pandemic, the country was aided by a strong recovery in the US economy. Besides that, Mexico stands out as one of the main beneficiaries of nearshoring, which involves the reallocation of investments and facilities by American companies from Asian countries, especially China, to geographically or historically closer nations.

Mexico has also implemented a relevant process of monetary tightening and saw its inflation indexes fall, chiefly in goods and commodities. However, it failed to keep inflation expectations anchored.

Growth above the potential ate away at the economy's idle capacity. Job creation, combined with the emigration of Mexicans to the United States, led to an unprecedented low level of unemployment, that is, below the equilibrium level. This hindered the path towards consistent disinflation.

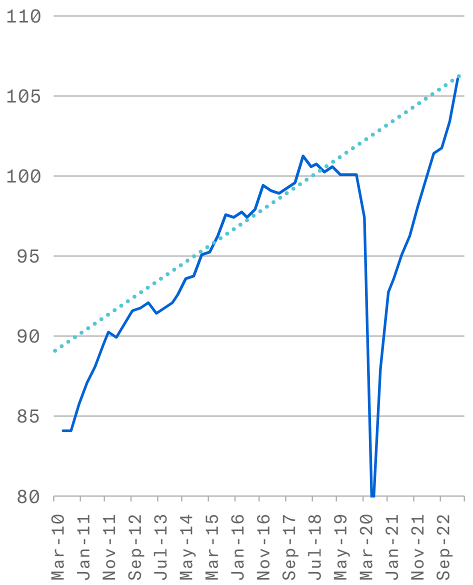
Despite a virtually null fiscal stimulus and tight monetary policy in Mexico, the steady inflow of dollars from Mexican immigrants has kept consumption high. As a result, strong economic growth in the last quarters led the Mexican Central Bank (Banxico) to adopt a cautious approach in the face of inflationary risks, lowering expectations for interest rate cuts.

The Central Bank argues that, while the economy keeps growing above its potential and the labor market remains hot, it is wise to keep interest rates stable and restrictive. This occurs even with these rates considerably high in comparison to the national historical pattern. Banxico's main goal is to avoid further deterioration of expectations, which could increase the cost of the future inflation convergence process.

We consider the Mexican case as "no landing". The commander has yet to see the runway and so has not signaled its crew to prepare for landing.

FIGURE 10:
Mexico's domestic demand (Consumption + Investment)

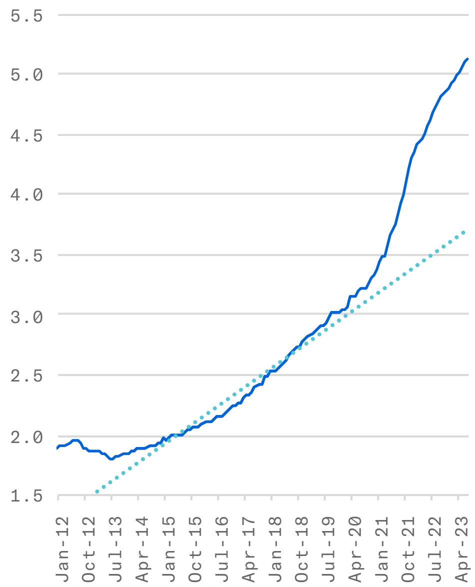
Index number, 4T19=100



Source: INEGI (Mexican Institute for Statistics and Geography), Mar Asset Management

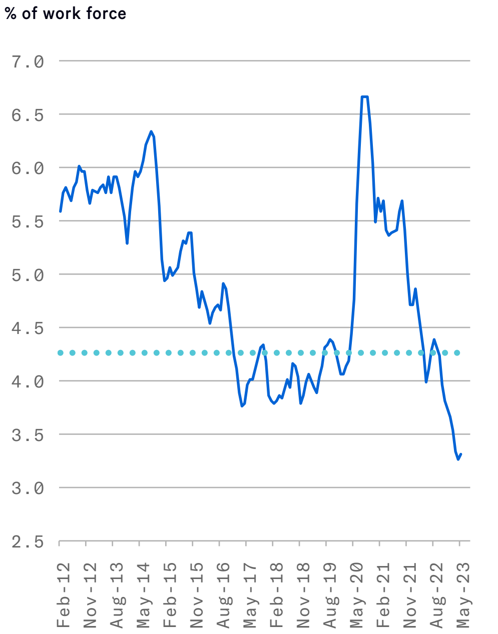
FIGURE 11:
Remittances by Mexicans that immigrated

US$, billions, MM12 mo.



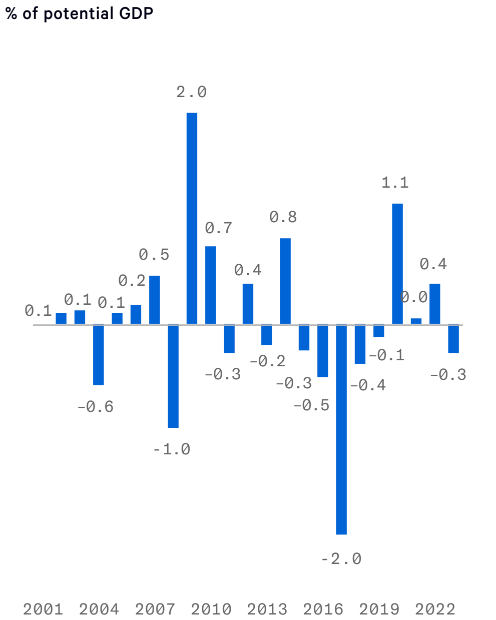
Source: Banxico, Mar Asset Management

FIGURE 12:
Mexico's urban unemployment rate



Source: INEGI (Mexican Institute for Statistics and Geography), Mar Asset Management

FIGURE 13:
Structural fiscal stimulus in Mexico



Source: IMF, Mar Asset Management

Brazil

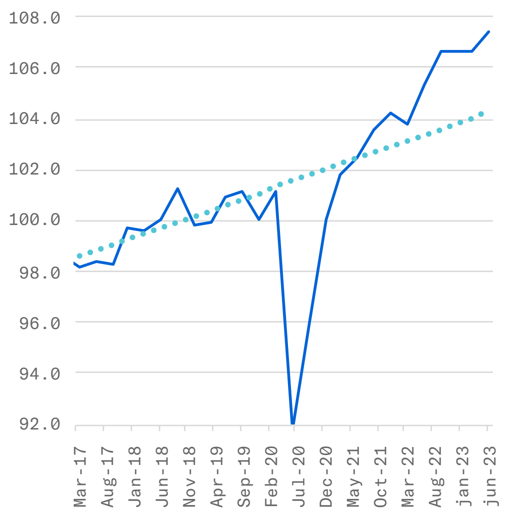
The Brazilian scenario is more complex. Considering the current stage within the economic cycle, there are some similarities with the situation in Mexico. Surprisingly, despite the real interest rate being at a restrictive level for over 24 months, the economy's idleness level has decreased consistently. The unemployment rate has fallen since the end of the interest rate hike cycle, dropping from 8.5% to 7.7%. Furthermore, the manufacturing production capacity usage is above the historical average.

GDP growth has been more resilient than expected by most economists. In this context, the latest National Accounts report was especially remarkable. Firstly, growth largely exceeded expectations, reporting a 0.9% increase compared to the previous trimester, against the expected consensus of 0.3%. Secondly, the growth components revealed a strong increase in the sectors more sensitive to monetary policy. Household consumption in 2023's first quarter was reassessed from 0.2% to 0.7%.

Growth in the following quarter was even higher, with a 0.9% increase compared to its predecessor. This indicates that household consumption remains strong and is gaining momentum, despite restrictive interest rate conditions and the negative contribution of credit stimulation.

FIGURE 14:
Brazil's domestic demand (Consumption + Investment)

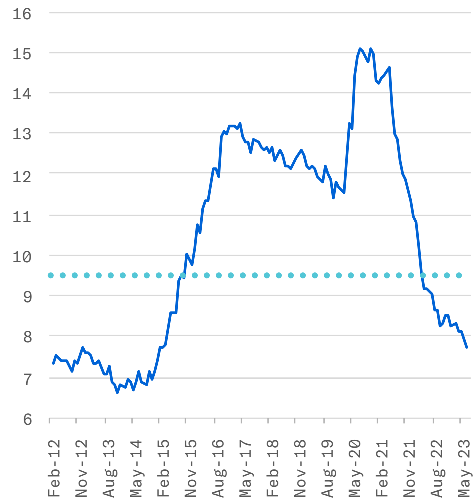
Index number, 4T19=100



Source: IBGE (Brazilian Institute for Geography and Statistics), Mar Asset Management

FIGURE 15:
Unemployment Rate

%, monthly and seasonly adjusted



Source: IBGE (Brazilian Institute for Geography and Statistics), Mar Asset Management

The widely employed argument that the positive surprise in the 2023's first quarter GDP was centered on the agricultural sector and that household consumption was consistently slowing down due to the tight monetary policy effects, something that has always been seen by us with skepticism when we observed the intense and continuous growth of income and wage mass[2], was discredited with the 2023's second semester GDP report and reassessment of the first trimester's data.

Despite real interest rates being kept much higher than the neutral level in the past quarters , this tightening was not enough to make up for other positive demand stimuli present in the economy. As a result, there was a narrowing of the output gap, which tends to put pressure on inflation in the cyclical sectors down the road.

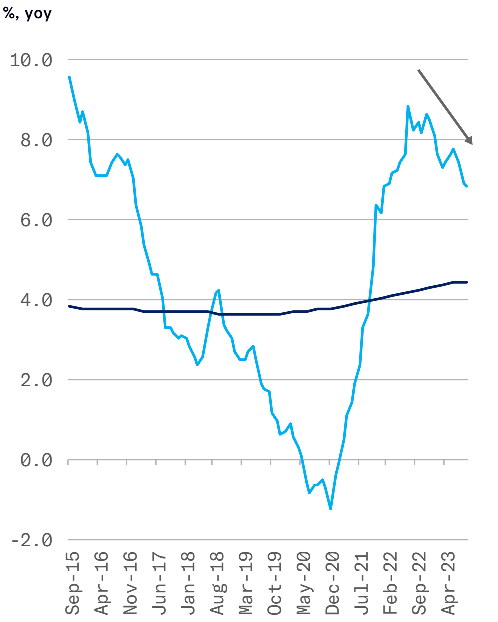
2 See, for example, our Macro study "Interest Rate in Brazil - first to go up, fist to come down?" published in September 2022 (link).

The trend of positive demand surprises accompanied by declines in headline inflation is not unique to Brazil. This phenomenon has been observed in many countries that adopted similar responses to the pandemic.

Therefore, even though there is a temporal coincidence between the increase in interest rates and the reduction in inflation in Brazil, it is difficult to assert a direct causal relationship between these two factors. This is due to the fact that the restrictive interest rates were not sufficient to generate the expected opening of the output gap, nor were they able to keep long-term inflation expectations aligned with the established target.

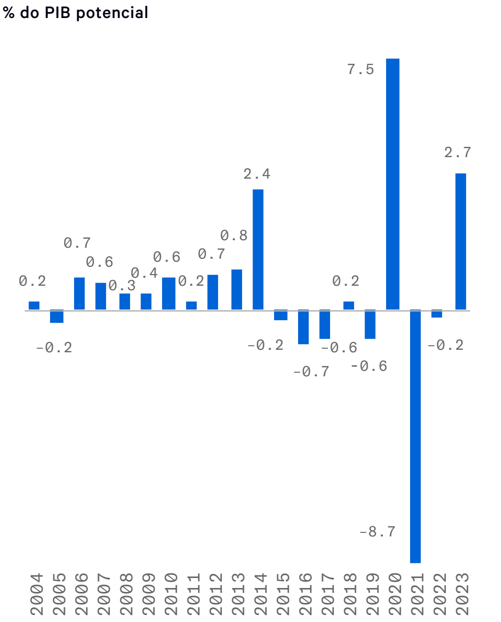
The only break in place over the vigorous dynamics of household consumption is being lifted off with the onset of the interest rate cut cycle. We are already witnessing an important loosening of financial conditions, relevant ex-ante interest rate reduction, as well as the levels of default by individual persons stabilizing around historical averages.

FIGURE 16:
1-year ex-ante real interest rate and neutral rate estimated by the BCB



Source: BCB, Bloomberg, Mar Asset Management

FIGURE 17:
Structural fiscal stimulatus projected by the IMF for Brazil



Source: IMF, Mar Asset Management

Fiscal

From a fiscal perspective, we are witnessing a historical structural expansion in 2023. It will be the greatest in the last 20 years, except for 2020.

It is surprising to notice how little attention markets have been paying to the fiscal stimulus's impact on economic activity in 2023. Fiscal debates have focused almost entirely on the projected trajectory for future indebtedness.

When analyzing the public debt trajectory, a simplified way to understand the scope of the problem is acknowledging that the Transition *PEC* (Constitutional Amendment Bill), passed right after the presidential election result, allowed for a permanent increase in expenses close to 1.7% of GDP. To go back to the starting point and stabilize the debt dynamics, the government would have to permanently raise its tax burden, also by 1.7% of GDP.

Early this year, the Minister of Finances demonstrated confidence in increasing tax collection. He went as far as promising to eliminate the primary deficit in 2023 and presented a wide range of measures that would supposedly lead to such result[3]. In April, during the Novel Tax Framework presentation, a GDP primary deficit of 0.5% was projected for the year at hand[4]. However, the current primary results ended up showing this projection was exceedingly optimistic.

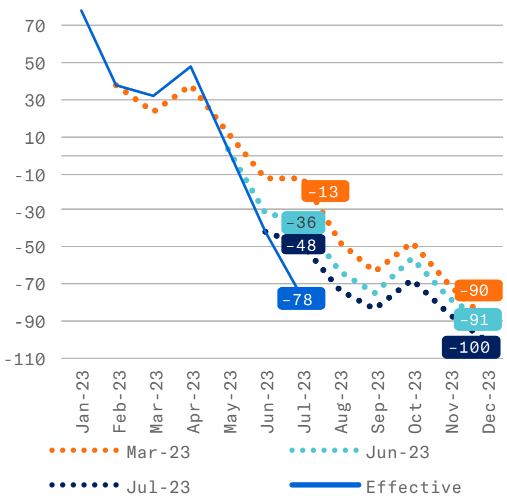
How we perceive the fiscal debt has been worsening throughout the year, despite the positive surprises in GDP growth. Up until recently, the general expectation was that of GDP growth close to zero , associated with a fiscal debt at around 1.0% of GDP. These days, GDP growth projections are surging to 3.0% and, according to our assessment, the primary deficit will likely top 1.3%.

3 https://www.gov.br/fazenda/pt-br/assuntos/noticias/2023/janeiro/fernando-haddad-apresenta-conjunto-de-medidas-para-recuperacao-fiscal.

4 https://www.gov.br/fazenda/pt-br/centrais-de-conteudos/publicacoes/apresentacoes/2023/apesentacao-arcabouco-fiscal.pdf/view.

FIGURE 18:
Accumulated primary result – projections (Prisma) vs. effective

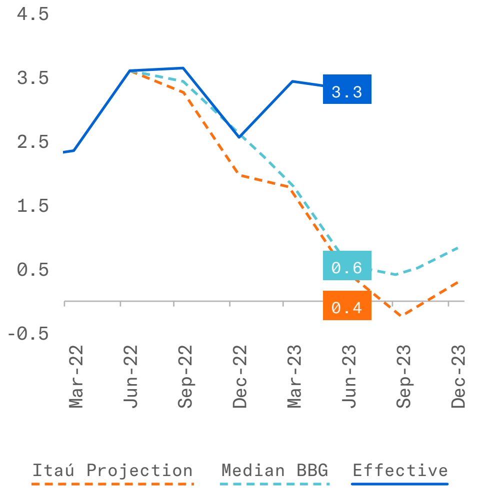
R$, bilhões



Source: National Treasury of Brazil, Mar Asset Management

FIGURE 19:
Projected GDP growth vs effective

%, yoy



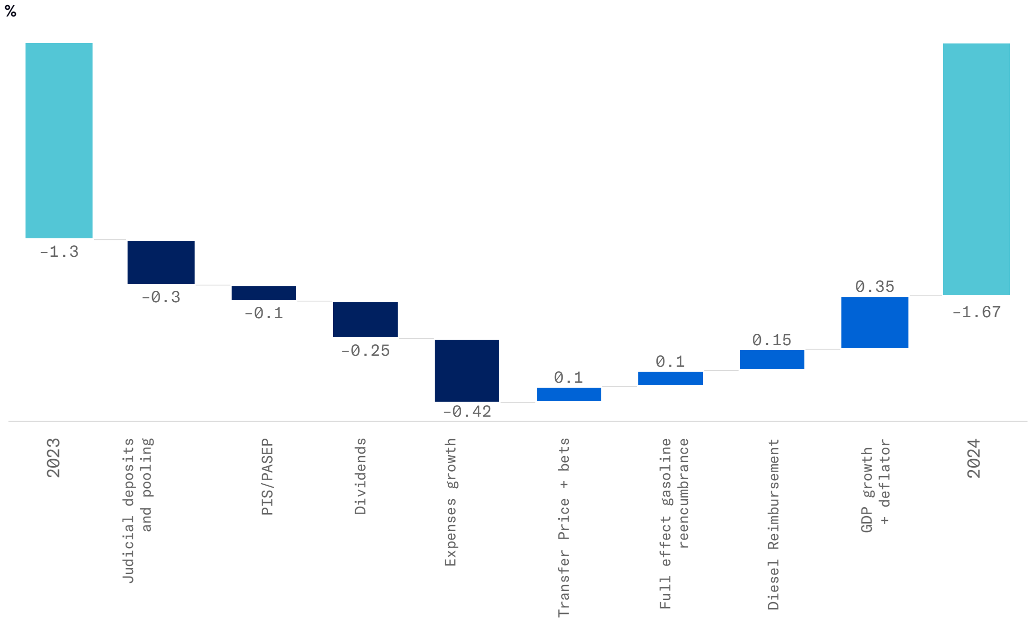
Source: IBGE (Brazilian Institute for Geography and Statistics), Itaú, Bloomberg, Mar Asset Management

The slowing down in tax collection does not stem from the economic activity itself, but rather from commodities' prices. Revenues from Income Tax on labor income and social security contributions grew more than 4.5% by July in comparison to the same period in 2022, in actual figures. The greatest negative impact to tax collection comes from royalties' revenues, dividends and Income Tax on the largest companies' profit, such as Petrobras and Vale.

The fiscal challenge to be faced in the 2024 budget is precisely the same size as the deficit left by the Transition PEC, equal to 1.7% of GDP. This means we are treading towards the last quarters of 2023 without any increase in structural tax collection, contrary to what was promised early this year.

At the *PLDO* (Budget Guidelines Bill of Law) presentation, the government again listed tax collection measures, aiming at zeroing the deficit in 2024. This list does not seem credible to market analysts when we observe its projections for next year's primary deficit. Even the government seems to have little conviction on its capability to deliver it, which is clear in the many times it has discussed changes to the target system. That is, are we back to having a fictitious budget piece?

FIGURE 20:
2023 primary result and 2024 starting point for primary result



Source: National Treasury, Mar Asset Management

An alternative to solving the fiscal problem is through greater growth. If there is a perspective of GDP growing rapidly in the following years, the debt sustainability issue could be attenuated. The repeated positive surprises in GDP growth in the post-pandemic period led to speculation that this way out was feasible. However, we doubt this idea.

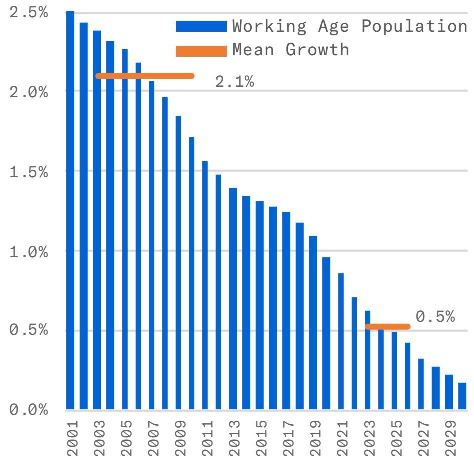
The hypothesis states that we had an increase in potential GDP growth due to the accumulation of reforms implemented these past years. We agree on the importance of the reforms, but we understand its effect is more concentrated on avoiding a steeper reduction in potential growth than effectively increasing it.

Productivity shows slow and marginal changes throughout time (measured by PTF[5]), and what seems to be happening these past years is a downward trend in productivity and not the other way around. What we know with a higher degree of certainty is that potential economic growth stems from population growth, and it has been dropping fast in Brazil .For this reason, we and the market consensus see a relevant drop in potential growth throughout the last decade.

Unlike the US, where immigration has temporarily stimulated GDP potential, in Brazil we believe that excess growth shall account for more inflation up ahead.

FIGURE 21:
Population growth between 20-64 years of age

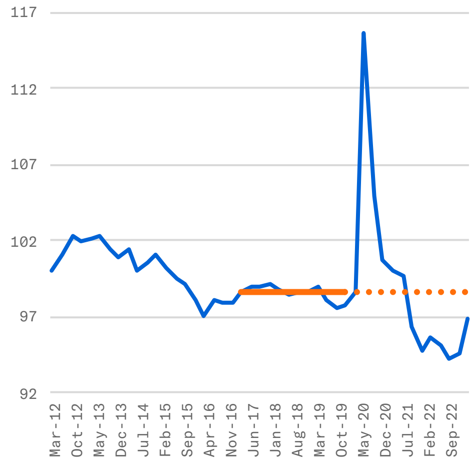
%, anual



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

FIGURE 22:
Economy's aggregate productivity indicator (Total Factors Productivity)

Index number, 2012=100



Source: Régis Bonelli Observatory, Mar Asset Management

5 GDP can be disaggregated into labor (L), capital (K) and factor productivity (TFP). There is an effort by some institutions to try to estimate the evolution of the capital stock and the degree of use of these two factors (K and L).

$GDP_t = PTF_t * (Capacity\ Utilization * K)^{\alpha}\ (Hours\ Worked)^{1-\alpha}$

This decomposition shows a negative shock to productivity in Brazil in the post-Covid period. After the initial shock of the pandemic, due to the more concentrated closure of lower productivity services, the PTF stabilized at a very low level, around 3% below the pre-pandemic one.

Politics

The political challenge imposed by Congress to the current administration has been celebrated by the market as a sign of power balance between the Executive and Legislative branches. Generally speaking, we agree on this. The same legislature that approved the expense increase via the Transition PEC is now, for the sake of this power balance, hindering the implementation of measures to increase tax collection.

In the fiscal context, the political power balance points to the possibility of continued deficits in the future. This happens because, removing almost 2% of GDP from the economic establishment through recurring tax hikes is no simple feat for a government with limited popular support, especially when such support is concentrated regionally[6].

It is always viable to find political solutions to overcome resistance to higher taxation. The posing issue is to what extent is President Lula willing to give in political power to a center-right Congress, in order to meet the primary deficit goal promised by Minister of Finances Fernando Haddad.

We see a clear resistance from the ruling PT (Workers' Party) and President Lula in transferring more power to the "Big Center" (a collection of usually non-ideological centrist parties), particularly to its greatest representative, Artur Lira (President of the Chamber of Deputies or House Speaker in US political system), in the midst of the upcoming municipal elections.

With market prices stable, GDP positively surprising and the president's growing popularity, it seems more likely for the government to adopt a more rigid attitude towards Congress. The discussion on the higher taxation agenda will remain a significant challenge, and Congress, in order to pressure the administration, is already pushing for an agenda that may have a negative fiscal impact, such as the tax exemption bill for city halls' payroll, proposed in late August.

6 We dove deeper into this topic in previous letters. For example, in our letter"Samba ou Tango", from April 2023 (link).

Most likely a new power balance will be brokered, but the fiscal developments from this process are short-sighted.

The combination of factors present is of great concern to us. It includes an economy that, in our view, is running on a positive gap, an unemployment rate historically low and incompatible with the inflation target, inflation expectations above the target, a structurally expansive fiscal attitude, significant risks relative to the public debt course, the perspective of an administration that does not tolerate economic slowdown and, lastly, a central bank facing considerable political pressure, which in turn opted for an aggressive start to the loosening of the monetary policy.

About the BCB

The possibility of a perfect landing brought by the American case, together with strong political pressure, may engender a perilous quest by the Brazilian Central Bank (BCB) to fulfill a "more than perfect" disinflationary process: a drop in inflation coupled with unemployment reduction and a pickup in domestic demand, that is, the least costly convergence in the world.

Even the Fed has doubts concerning the consistency of the American disinflationary process, in spite of there being core services inflation close to pre-pandemic levels, strong positive shock from labor, unemployment compatible with inflation on target and anchored expectations. The BCB, however, very much to our surprise has been celebrating Brazil's disinflation as a poster boy for the world, despite service inflation being above 5%, unemployment rate incompatible with inflation on target and long-term expectations consolidated above the target.

The discussion on monetary policy and interest rates in Brazil had disappeared from the news these last few years. The *Selic* policy interest rate, which went on to be regarded as a technicality and set by specialists in BCB's meetings, was no longer of interest to the general public.

This change was an important cultural evolution in the country, allowing for the approval of independence to the Central Bank as a significant institutional advancement.

Early this year, President Lula, concerned with the risks of an economic slowdown that could derive from restrictive monetary policy – which precisely seeks to cool down the economy – launched an intense campaign against the BCB's decisions and, in particular, against its president, Roberto Campos Neto.

From this moment on, the assessment of future monetary policy decisions in the markets was filtered by an old approach, the Realpolitik. The conceived logic was that monetary decisions should take political reality into account to find the best practical feasible solution, that is, embrace the lesser of two evils.

This notion, as was conceived, partly turns away from inflation convergence, in order to reduce political pressure that could threaten the recently-achieved Central Bank independence.

The risk of introducing Realpolitik into monetary policy decisions is putting the inflation target on the back burner, given that other variables must be balanced out in favor of multiple objectives.

When markets, analysts and journalists start regarding politics as one of the "objectives" of monetary policy, inflation expectations may gradually start straying away from the target, as this exogenous element gains strength.

The monetary policy dynamics greatly depend on the expectations of market agents. These expectations are not only sensitive to the technical implementation by the Central Bank but also to the perception that economic agents have regarding the independence of the Monetary Policy Committee (COPOM) in its decisions.

This mix, combined with a dose of Realpolitk, might very well be inflammable. If handled with extreme care, it could be manageable, but the margin of error is narrow and any spark could ignite during flight.

We are not inferring that the BCB's decisions has suffered political influence, but we have found that analysts and administrators who considered the political variable in their analysis did a better job at assessing and foreseeing, even if by coincidence, the recent BCB decisions.

Thus, it is inevitable that most analysts and administrators start considering this new variable in their assessments, further contaminating the expectations formation process.

The current scenario shows a delicate balance among markets, analysts, the BCB and the administration, which looks fragile and unstable.

The quest for harmonizing monetary and fiscal policy, often quoted by the Minister of Finance, seems to be heading in the opposite direction, given the current stage within the economic cycle. We understand that the harmonization the Administration seeks is that of a stronger growth in the short term. This results in fiscal stimuli, while concurrently pressuring the BCB to flexibilize monetary conditions. This harmonization meets the political demands of the new government early into its term, but conflicts with the inflation convergence goal and creeping public debt control.

While Chile's "Hard(ish) Landing" is underway, the US aims at the runway for a "Perfect Landing" and Mexico is trying out the "No Landing" way, Brazil suggests a "WonderLanding" in some way.

Rear-view mirror

For those who read our newsletters regularly, our concern with the economic policy's conducted throughout the year is no surprise. Now, it is clear that our approach was not on point when we compared to the extremely positive price dynamics since April.

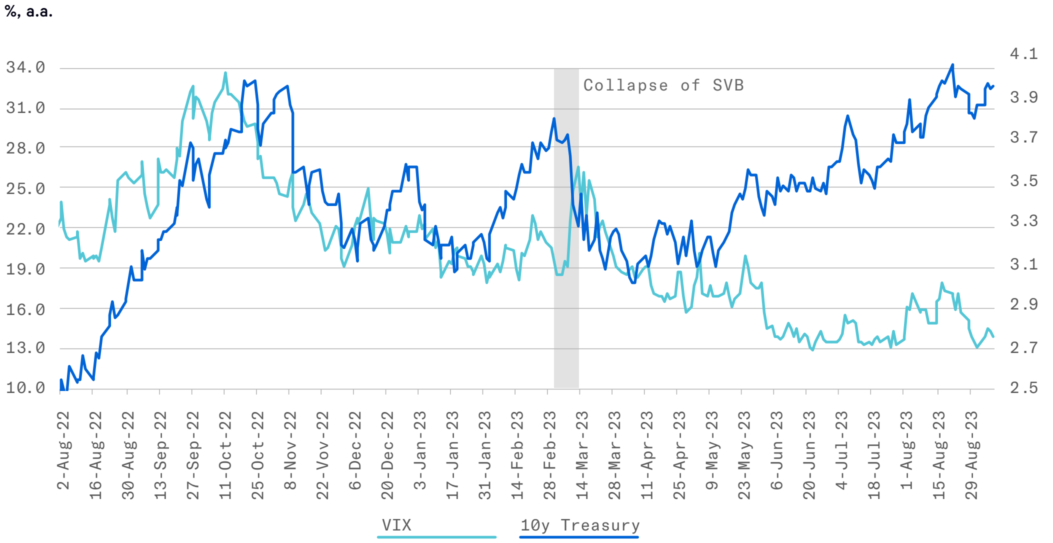
Our Mar Absoluto 2023's strategy has not performed well and it reflects our distancing from the market consensus view.

We acknowledge we mistook the rupture of a powerful correlation that occurred in global markets since the Fed began the interest rate hike cycle.

Throughout this cycle, the 10-yr. US Treasury bonds rate showed a strong positive correlation with the implicit volatility index (VIX) measured in the S&P 500, also known as the "fear index". The underlying belief was that the higher the US interest rate, which works as the main cost of opportunity for global assets, the worse it would be for risk assets. Higher interest rate, higher VIX.

The Silicon Valley Bank going bankrupt resulted in the rupture of this correlation. Because of a banking crisis scare in the US and a possible recession, the Treasury bonds interest rate fell, whereas the VIX rose.

FIGURE 23:
10-yr. US Treasury bonds rate and VIX index



Source: Bloomberg, Mar Asset Management

Then, we undertook a deep assessment of similar past events in the US. The equities team dove headfirst into understanding the SVB, aiming to determine whether this was a one-time event or evidence of fragility in the US financial system[7].

7 The study can be found at the following link.

Our findings and studies were later shared[8], highlighting that this event in particular was specific and that US economic growth would go back to its due course. We also believed that the Fed would replicate its usual approach, raising the US interest rate.

We understood the previous correlation would surface again; high interest rates meaning hardship for risk assets.

However, surprisingly enough, the reaction from markets after the event was different than expected. Despite resuming interest rate hikes, the general market understanding was that the lack of a financial crisis was good enough for business. This took place regardless of higher interest rates' comeback.

Going forward, the VIX index started declining, dropping from levels around 30% early this year to about 10% in the months that followed the SVB episode.

The improvement in the perception of global risk drove a remarkable risk assets rally, including those from emerging countries. There was an increase in stock exchanges, emerging currencies' strengthening and long-term interest rates reduction, notwithstanding boosts to US interest rates.

Since then, the divergence between US bonds interest rates and the VIX have widened. However, this divergence's sustainability is questionable, for it is likely that, at some point, there will be a convergence. The uncertainty, therefore, is whether this convergence will be the outcome of falling US interest rates or rising VIX (which would lead to a drop in risk assets).

A higher probability of a "perfect landing" suggests that convergence shall take place, at least partly, by means of interest rate reduction.

8 Link.

In the business of portfolio management, divergence in relation to the consensus is necessary to generate alpha. However, when we do diverge from the market and our course does not prove itself, we gradually shed our exposure.

We find it hard to "turn the hand", that is, invert our stances to capture price dynamics that go against what seems most likely. As a first risk management measure, our strategy is to reduce portfolio exposure, reassessing our ideas and perspectives. Should they hold, we wait for a more advantageous moment in the future to implement them once again.

This was the playbook we adopted throughout these past months. After virtually resetting our main losing positions this year, we are just back to adding risk to the portfolio.

With regards to macroeconomics, we started an applied stance (falling rates bet) on US interest rates, after a long period of betting on its spikes.

Currently, as we deem a "soft" or "perfect landing" ever more possible in the US, we observe that the interest rate curve is close to the highest levels in the past years. These are tell-tale signs of a promising opportunity, in which to adopt a strategy of betting on falling rates.

In the Brazilian scenario, concerns about the fiscal and monetary situation are mounting. Our most pessimistic perspective in relation to long-term interest rates seems to be more welcomed by the market, but for now, they remain close to this year's minimum levels.

We have decided to resume our payers on long-term interest rates in Brazil, based on the premise that the current levels reflect an optimistic scenario, which to us is not very likely.

We are again diverging from the predominant market opinion, but this time around in more favorable conditions with more advantageous prices. Therefore, we have chosen to increase our exposure.

Besides that, during the second quarter, we increased our exposure to equities, using some of our cash to buy companies with idiosyncrasies less dependent on the local macroeconomic conditions. We believe current valuation gives us enough margin of safety to earn more than 12% per year, in real terms, in the long term.

Five companies represent more than 2/3 of the risk in this class, amongthem are: Eneva, Alupar and Equatorial. Although we will not get in detail behind each investment thesis as of now, these choices share certain elements we look for:

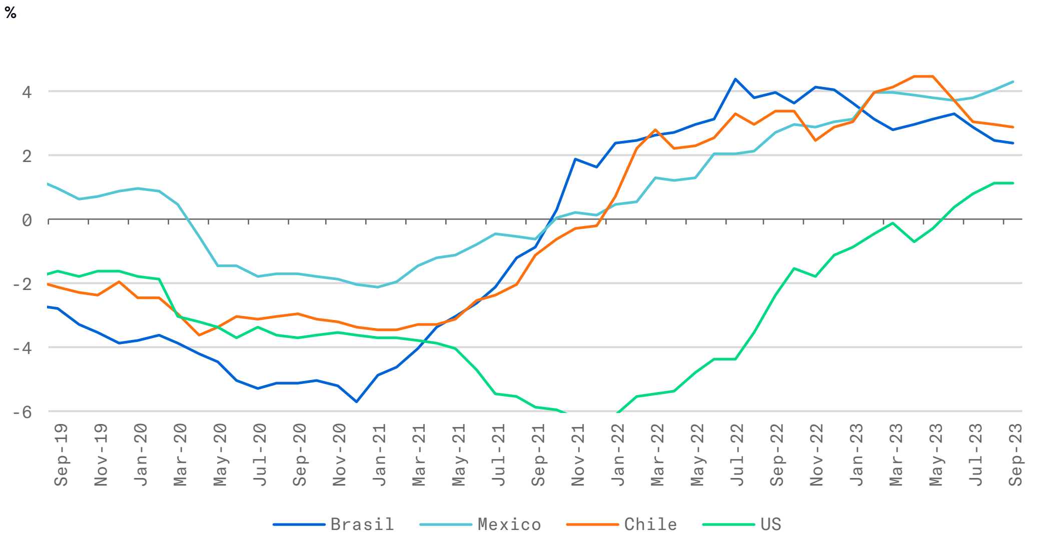
1. current assets undervalued for its operational dynamics and/or risk associated with cash flow;
2. plentiful optionalities, especially in future capital allocation in the short/medium term; and
3. well incentivized businessmen and management team with financial
4. discipline, good capacity for identifying opportunities, mainly in adverse scenarios.

Furthermore, these are companies with structural protection against inflationary pickup.

Regardless of how it will take place , or even if there will be a landing, the best we can do for now is buckle up.

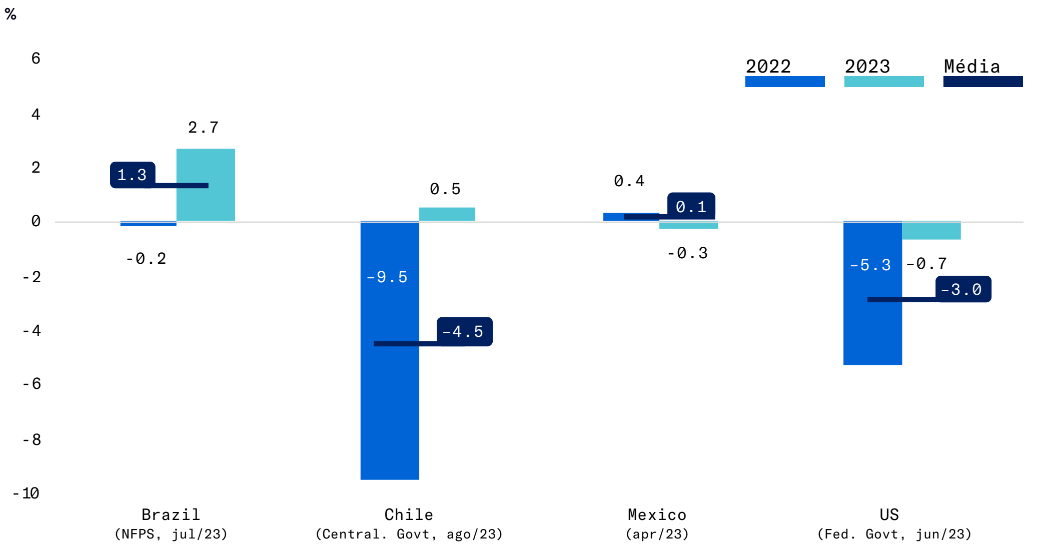
More Figures

FIGURE 24:
Differences between the 1-yr. ex-ante real interest rate and neutral rate by country



Source: Bloomberg, Mar Asset Management

FIGURE 25:
Estimated structural fiscal stimulus by the IMF

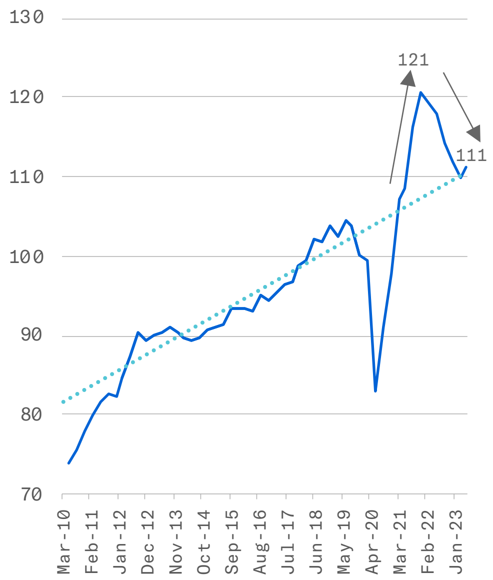


Source: FMI, Mar Asset Management

Domestic demand

FIGURE 26:
Chile (Hardish Landing) – after raising by almost 20%, domestic demand has contracted plenty in the past trimesters

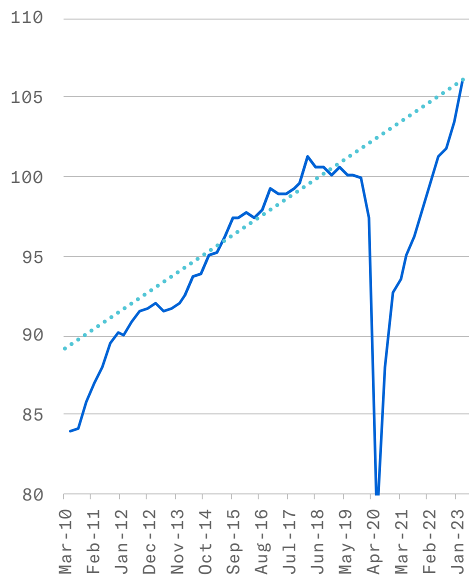
Index number, 4T19=100



Source: INE, Mar Asset Management

FIGURE 27:
Mexico (No Landing): Mexico's economy keeps growing at a pace above potential

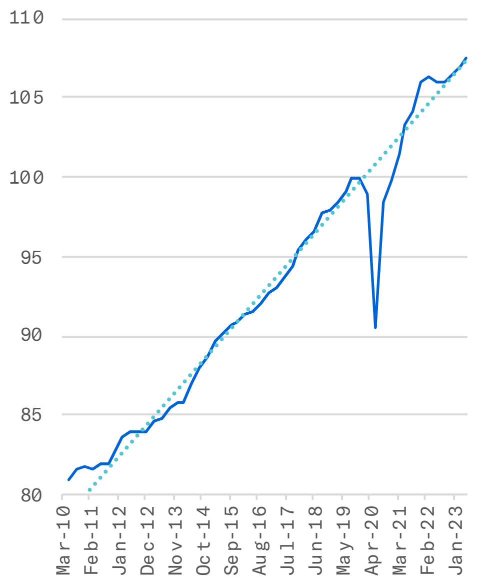
Index number, 4T19=100



Source: INEGI, Mar Asset Management

FIGURE 28:
US (Perfect Landing) – domestic demand has returned to the trend in a perfect way!

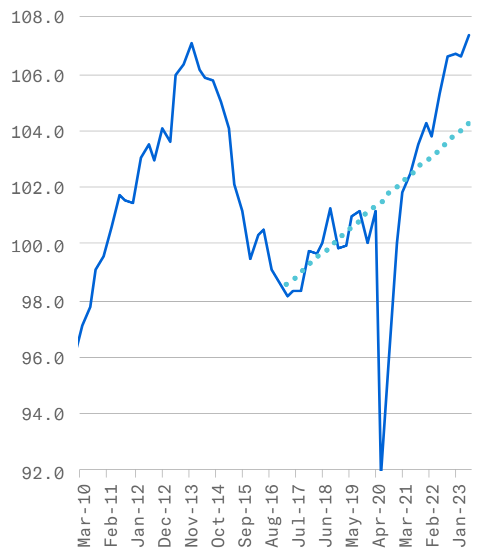
Index number, 4T19=100



Source: BEA, Mar Asset Management

FIGURE 29:
Brazil (Wonderlanding): domestic demand is high and creeping

Index number, 4T19=100

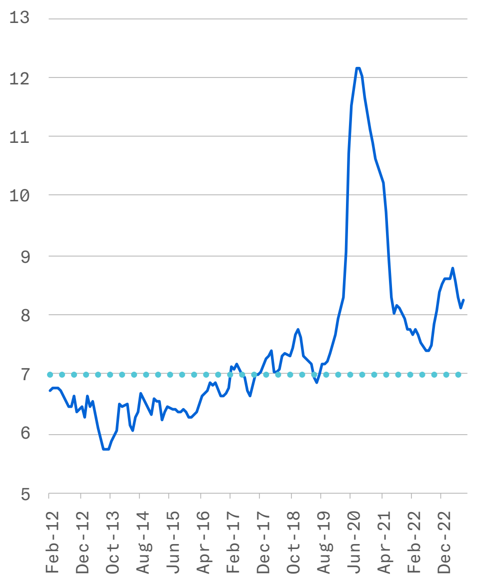


Source: IBGE, Mar Asset Management

Unemployment rate

FIGURE 30:
Chile: unemployment rate has risen recently and is above the pre-pandemic level

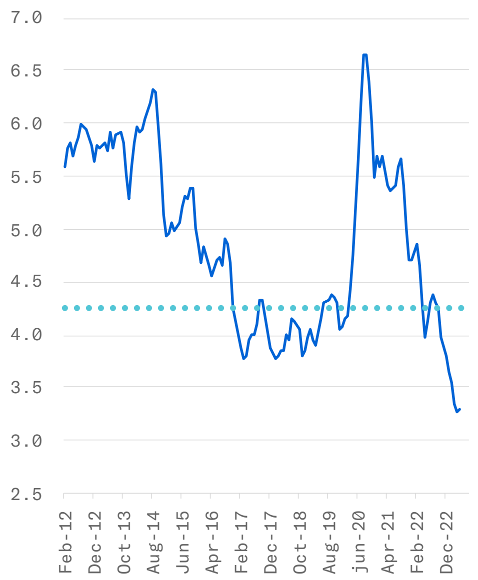
% of work force, with seasonal adjustment



Source: INE, Mar Asset Management

FIGURE 31:
Mexico: urban unemployment rate is in the lowest historical level ever

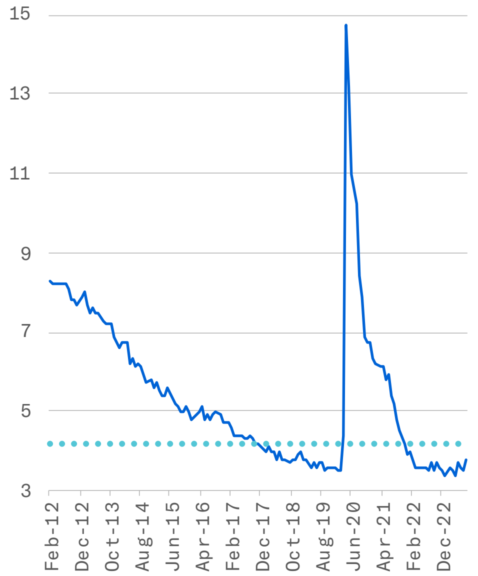
% of work force, 3mma with seasonal adjustment



Source: INEGI, Mar Asset Management

FIGURE 32:
US: unemployment rate stagnant in the pre-pandemic level despite strong employment rise

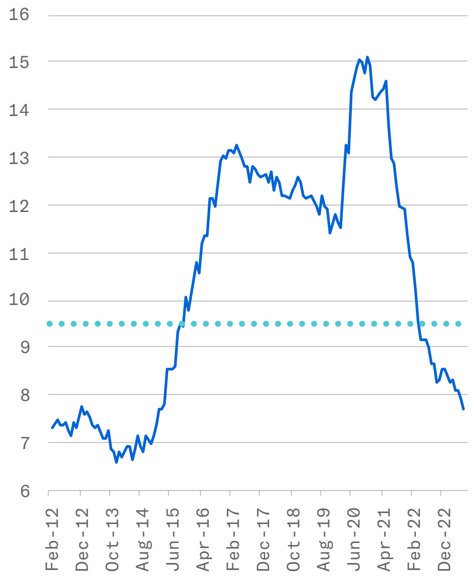
% of work force, with seasonal adjustment



Source: BLS, Mar Asset Management

FIGURE 33:
Brazil: unemployment falling at a rate never seen before with inflation is on target

% of work force, monthly and seasonally adjusted

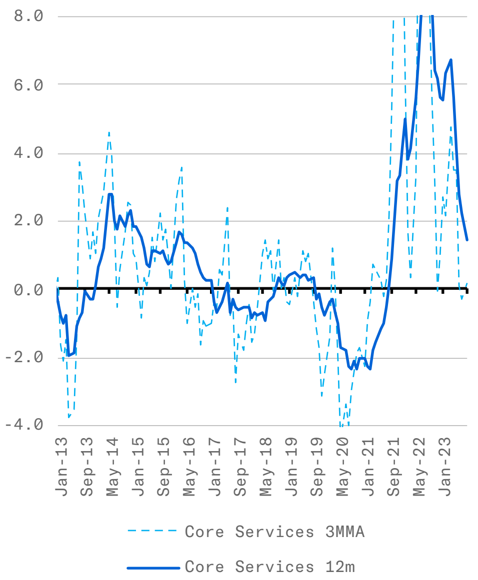


Source: IBGE, Mar Asset Management

Services core inflation

FIGURE 34:
Chile: services inflation descending

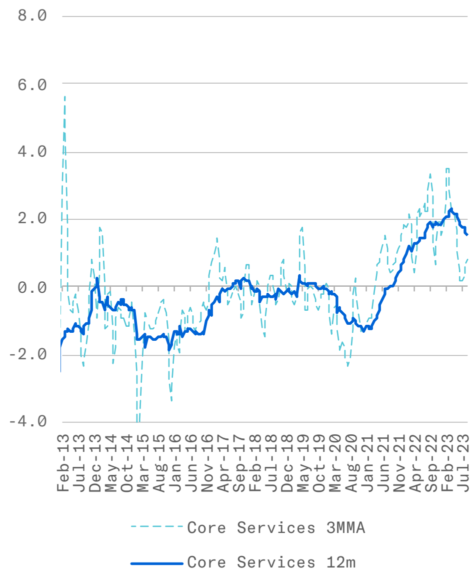
%, deviation from target



Source: INE, Mar Asset Management

FIGURE 35:
Mexico: risk of inflation picking up again

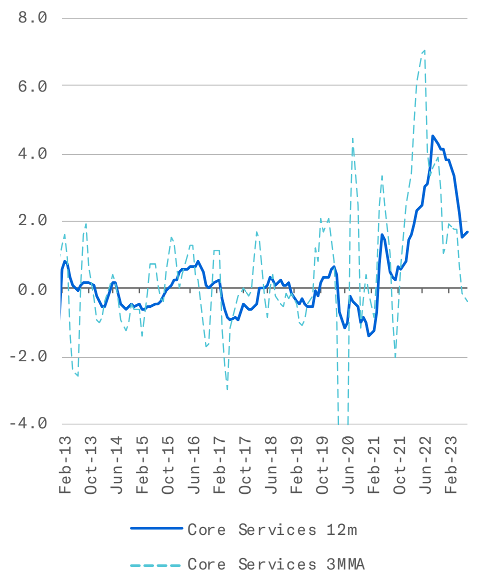
%, deviation from target



Source: INEGI, Mar Asset Management

FIGURE 36:
US: services inflation seems to be converging

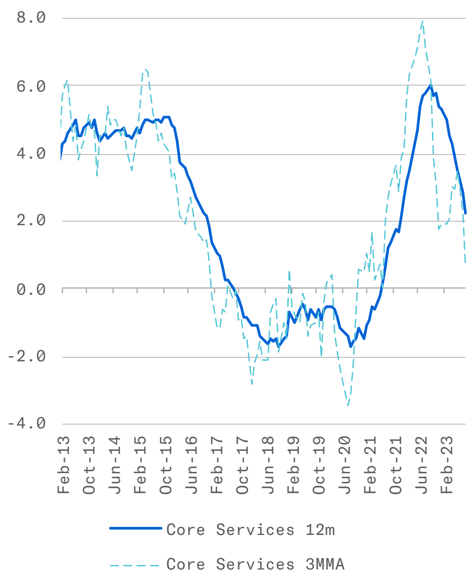
%, deviation from target



Source: BLS, Mar Asset Management

FIGURE 37:
Brazil: services inflation relatively stable at above the target since early this year

%, deviation from target

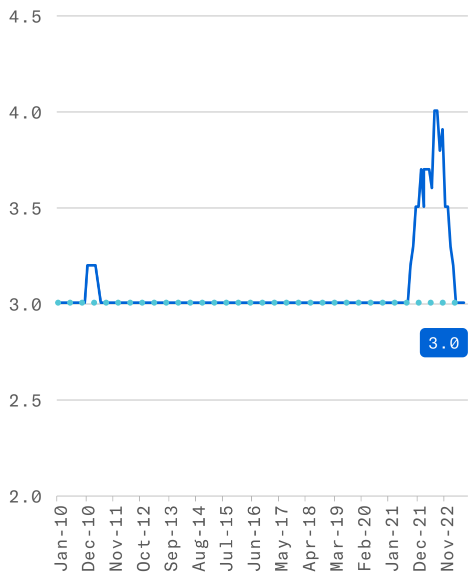


Source: IBGE, Mar Asset Management

Inflation Expectations

FIGURE 38:
Chile: harmonized fiscal and monetary policies re-anchored inflation expectations

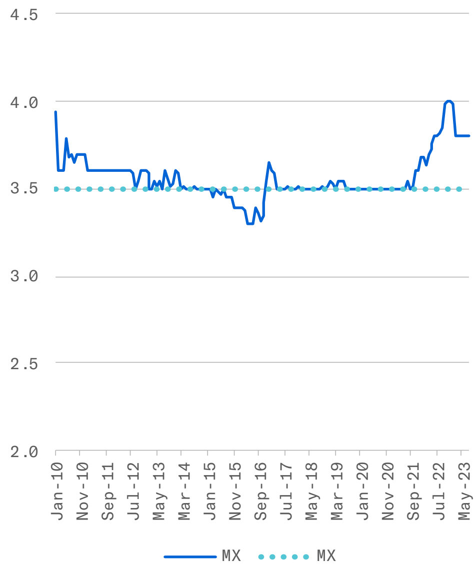
%, inflation expectation 2 years ahead and inflation target



Source: BCCh, Mar Asset Management

FIGURE 39:
Mexico: Banxico acts to re-anchor expectations

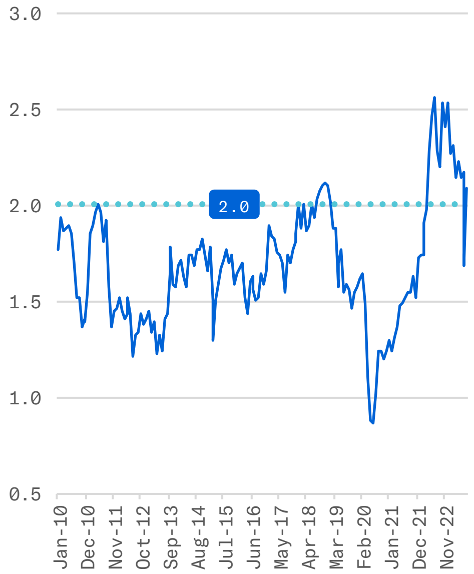
%, inflation expectation 5-8 years ahead and average pre-pandemic inflation



Source: Banxico, Mar Asset Management

FIGURE 40:
EUA: Risk of expectations' unanchoring in the US was contained

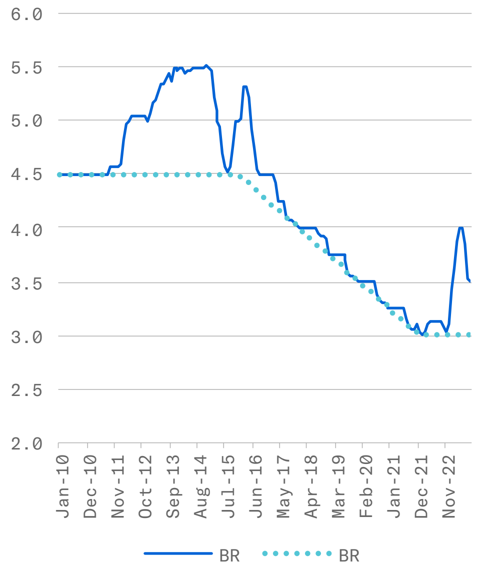
%, inflation expectations 5 years ahead



Source: Cleveland Fed, Mar Asset Management

FIGURE 41:
Brazil: BCB initiated a loosening cycle despite expectations above the target

%, expectations and targets 2 years ahead



Source: BCB, Mar Asset Management

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