Dark Clouds on the Horizon

December 2022

Dear investors,

This past month, the IBOV fell 2%, but the decline was significantly worse than it appears, since that figure is masked by the movement of VALE3 which accounts for 18% of the index's portfolio and rose 28%, bucking the broader market trend. Excluding VALE3, the IBOV would have fallen 9% in November.

The main driver of the decline is concern over the new government's fiscal policy, which has made clear its intention to increase public spending on social programs but has yet to explain where the additional resources to fund them would come from. The scenario the market anticipates is one of a widening government deficit, with a consequent rise in public debt and interest rates. Higher interest rates constrain economic growth and weigh on equity valuations. The outlook genuinely looks bleak, but it must be put in perspective before forming strong views about what it means for investments.

In our October letter, we discussed Brazil's system of government, and in our November letter we explored Brazil's position in the global economy. With that backdrop, we will now set out our view on the most recent developments in the Brazilian market.

The Transition PEC

One of the new government's first acts was to propose to the National Congress (through agreements with the presidents of the Chamber of Deputies and the Senate) a constitutional amendment (PEC) that would allow the executive branch to spend approximately BRL 198 billion per year above what the spending cap would otherwise permit, throughout the duration of Lula's term. Of that amount, BRL 175 billion would be allocated to the Bolsa Família program under the terms promised during the campaign, and the remaining BRL 23 billion could be spent on investments, but only in the event of tax revenues exceeding the 2023 budget projections.

To put these numbers in proper context: the government's fiscal budget for 2023, excluding amounts related to social security and public debt refinancing, is approximately BRL 1.9 trillion. The proposal (dubbed the "Transition PEC") would therefore authorize a real increase of approximately 9% in those public expenditures.

The problem with this PEC is that the new government is seeking permission to spend more without making clear where the resources to fund these additional expenses would come from. The alternatives, however, are well known. There are three main possible sources: i) increased tax revenue; ii) money creation (printing money); or iii) an increase in public debt. Let us consider each of these possibilities.

Increased tax revenue

There are only two ways to increase tax revenue: raise tax rates or rely on real economic growth.

In Brazil, the tax burden stands at around 34% of GDP, already a high level (the U.S. figure, for example, is approximately 24%). Passing tax increases therefore tends to be a politically costly process, especially for the new Congress, in which most deputies and senators were elected on platforms opposed to such a move. It is not an impossible path, but Brazil's tax burden has remained relatively stable over the past 10 years, hovering between 32–34%, even during periods when the executive branch would certainly have preferred to raise revenue.

Economic growth, for its part, would be the ideal alternative and appears to be what the new government is counting on but it depends on many factors outside the state's control, making it a risky assumption. The situation is analogous to a company that decides to increase its expenses in anticipation of generating new revenue: the additional spending is always guaranteed, but the additional revenue is not.

Currency issuance

In the extreme, the government could print new money and use it to pay its expenses. Since issuing currency does not create real economic value, the practical effect of this mechanism is for the state to appropriate a portion of the value of the money already in circulation in the economy. It is analogous to a controlling shareholder issuing new shares for themselves with no corresponding consideration, diluting minority shareholders and reducing the individual value of each share.

The use of this mechanism is always tempting for a government, since the general public understands little about how it works and tends to accept the inflation resulting from money creation more readily than an explicit tax increase. If governments were free to print money at will, they would tend to abuse the mechanism and trigger hyperinflationary crises. Brazil lived with high inflation from the mid-1970s until 1994, when the Plano Real was introduced and successfully stabilized the country's currency.

The very creation of central banks is linked to the need to control money creation in order to prevent economies from entering the negative spiral caused by the practice of printing money to finance public expenditure. The Central Bank of Brazil (BCB) was established in 1965, but went through a long maturation process before reaching, very recently, what are considered best practices.

Until 1988, the role of the BCB overlapped significantly with that of Banco do Brasil, which greatly reduced the BCB's influence over the country's monetary policy. Until 2020, the BCB was subordinate to the Ministry of Economy and, by extension, to the executive branch, which could replace the BCB's president at any time and dictate the country's monetary policy. It was only in February 2021 that our central bank became independent. The BCB president now serves four-year terms, beginning at the start of the third year of the President of the Republic's term and extending through the end of the second year of the following president's term.

This newly granted autonomy to the BCB was an important step, as it prevents the executive branch from engaging in abuses through monetary policy. Today Brazil has a mature legislative framework to regulate the BCB's operations and its relationship with the National Treasury (NT), which manages federal government finances. The main restrictions imposed are:

- The BCB may not extend loans to the NT. The Treasury's debt to the BCB may only be refinanced over time, with the amount adjusted for inflation. This prevents the BCB from issuing currency and transferring it to the NT, which could lead to the vicious cycle of printing money to cover fiscal deficits.

- The interest paid by the National Treasury to the BCB is set at market rates. No transactions between the two institutions may be conducted on preferential terms.
- Profits generated by the Central Bank from exchange rate variations on its international reserves are retained within the BCB itself, to cover future losses. This too was a recent development: previously, profits were transferred in cash to the NT and, when losses occurred, the NT would issue new government bonds to the BCB as payment.

Setting technicalities aside, the general message is that the Brazilian executive branch does not have the freedom to simply print money to fund its expenditures. To do so, it would need the support of the BCB president and authorization from Congress. That is the maximum degree of legislative protection we could reasonably expect.

Increase in public debt

If government revenues are insufficient and it also cannot issue currency to cover its spending, the National Treasury's only remaining option is to issue new government bonds to raise money from the market. This avenue, however, is also not entirely unrestricted: the Brazilian constitution limits increases in public debt through what is known as the Golden Rule (Article 167, Paragraph III). Under this rule, the government may take on new debt to finance investment, but is not permitted to increase indebtedness to fund the state's current expenditures (payroll, social benefits, debt interest payments, and the cost of running the public sector) except when authorized by Congress through a simple majority.

This constraint may not be fully effective, since if Congress approves a budget containing additional spending and the following year's revenue falls short of covering the new expenses, there would be little to do other than authorize the deficit to be covered by new borrowing. Even so, it is the maximum degree of legislative protection we could expect, as the executive and legislative branches acting in alignment can do virtually anything. This is precisely why the market fears this possibility, which would bring two problems:

The first is that resorting to increased debt to sustain current expenditures signals fiscal irresponsibility on the government's part, causing the market to assign greater risk to loans made to the National Treasury (government bonds) and therefore to demand higher interest rates. This in turn increases the government's debt service costs, worsening the fiscal deficit problem.

The second problem is that by borrowing to expand public spending, the government would increase demand for goods and services in the economy, which would fuel inflationary pressure at precisely the moment when our Central Bank is trying to bring it down. The likely consequence is that the Central Bank would keep interest rates elevated for longer, thereby constraining our economy's growth for a more prolonged period.

Impact on equity investments

We have noted on several occasions that interest rates are the gravitational force of financial markets: the higher they are, the more they pull asset prices downward. This happens because an increase in the benchmark interest rate also raises the discount rates used in discounted cash flow calculations (the fundamental method for estimating the value of assets in general) and the higher the discount rate, the lower the resulting valuation. In addition, higher interest rates reduce expectations for corporate earnings growth and incentivize capital to flow out of equities and into fixed income, amplifying the downward trend. This is why the stock market falls when interest rates rise, and recovers when they fall.

What we have described so far summarizes the reason for all the recent market stress. Let us now take a step back and assess this scenario through a wider lens, considering the factors that do not form part of this logical chain but remain relevant to our investments.

Tax issue

The trigger for the entire chain of potential fiscal problems that Brazil could face in the future would be the Transition PEC, which has not yet been approved in its proposed form. We know that our Congress is not renowned for its speed or pragmatism. The Workers' Party's intention is to pass the PEC before year-end, but contentious issues tend to move slowly through Congress and to be substantially watered down in the process. The PEC could be approved with softer terms (permission to exceed the spending cap by a smaller amount or for a shorter period) or might not even be approved this year, given that we are already approaching the parliamentary recess. If the matter carries over into 2023, it will have to be renegotiated with the newly elected Congress, which is less aligned with the Workers' Party.

It is not only the practical impact of the PEC that moves the stock market. A significant portion of the money invested in Brazilian equities is foreign capital, and seeing Brazilians themselves engaged in heated debates about fiscal responsibility, managers of international funds, who typically allocate a small percentage of their portfolios to Brazil, tend to simply reduce their Brazilian equity exposure until the situation stabilizes, rather than spending time trying to gain a deeper understanding of our political dramas. We have recently seen international funds selling, at very depressed prices, shares in companies that may actually be beneficiaries of the social spending the new government is planning operating under the pure rationale of reducing Brazil exposure. In moments of turbulence, many market participants behave in a less meticulous and analytical manner than is commonly assumed.

Expectations for the yield curve

Another market assumption is that future interest rates will follow the current yield curve, since it reflects the best projections available at any given moment. This is a reasonable assumption, but "the best projections currently available" is very different from "excellent projections." In February 2022, we published a letter discussing the difficulty of forecasting macroeconomic variables and showing what the market's track record looks like in predicting future interest rates. In short, it is quite poor. In December 2020, the market's projection for the SELIC rate in 2022 was 4.5%. This illustrates how quickly the macro environment can shift and completely confound market expectations.

Our approach is to acknowledge the inherent uncertainty in macro variables and focus on what we know with greater confidence: the interest rate is currently high and forms part of a temporary course of action by the BCB to combat inflation. The medium-term tendency is mean reversion. Actions by the new government could prolong elevated interest rates, as we mentioned, but there is a lengthy process before that materializes and as we can see from the reaction to the PEC, both the government and Congress would have to override numerous significant interest groups. It is always possible, but it does not strike us as particularly likely to happen at the catastrophic scale the market fears.

Between a rock and a hard place

From another angle, it is worth considering whether it is better to hold fixed income or equities in the event of a fiscal crisis. If interest rates rise due to government fiscal irresponsibility, that rise reflects an increase in the risk embedded in government bonds. Equities may continue to fall, but investing in domestic fixed income does not offer that much security in this scenario either.

Brazil holds the majority of its debt in local currency, so the risk is not a direct default by the National Treasury, but rather that an extraordinary money issuance could be used to retire a portion of the public debt that becomes unserviceable through normal means (though this would require congressional support, it is a possible maneuver in extreme situations).

Equities, on the other hand, may suffer from an economic slowdown, but they carry a natural hedge against inflation and against real interest rates remaining elevated for extended periods. The key concept to keep in mind is that a company that produces something genuinely useful to society will always have real economic value, regardless of the country's currency and interest rate regime. If the currency loses value, companies raise their prices and continue selling as long as there is demand for their products in the market. If interest rates rise, demand for credit will fall to a point that forces rates back down. In a greatly simplified way, this is the nature of the well-known economic cycles.

Investing outside Brazil could be an alternative, but it also carries its own challenges at present. Current exchange rates are not clearly favorable for taking money out of the country, and the global economy is not in its best shape either. The United States and Western Europe, the markets we typically view as safe havens, are heading toward a recession caused by monetary policy tightening to combat inflation, very similar to what Brazil adopted, but we made that move approximately one year before those countries did. In other words, they may take longer than Brazil to return to growth.

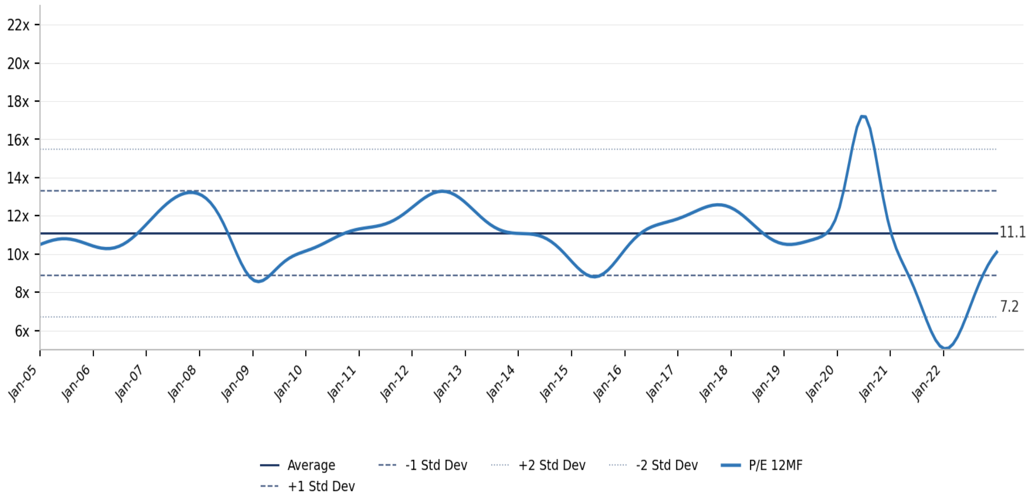
In short, there is no investment that is perfectly safe, offers excellent returns, and provides high liquidity simultaneously.

Focus on the facts

Although it is impossible to predict the exact moment of a reversal in the down cycle, we know we are far from its peak. The risk that remains is that we go through several more difficult years, but one must also consider the starting point from which we are emerging. We have just come through years of severe economic problems caused by the pandemic. A return to normality, in itself, should already ensure that the coming years are not as difficult as the last.

Moreover, we are currently seeing equity prices that are quite rare. In our time operating in the market, we have only seen anything comparable during the subprime crisis in 2009 and the Dilma government crisis in 2015. At prices at this level, some of our stocks have the potential to double in value over the coming years in a moderate macro scenario. Even if the economy delivers a mediocre performance, these stocks should still generate returns considerably above the benchmark interest rate. Equity investments will always carry the risk of loss in catastrophic scenarios, but the current risk-return profile strikes us as highly favorable in selected names. The chart below makes clear just how cheap equities are: the IBOV's average Price/Earnings multiple is 35% below its historical average.

IBOV Valuation Multiples – Price / Expected Earnings for the Next 12 Months



Source: BTG Pactual

Finally, we offer the observation that great investments are only made by moving against the market consensus. It could not be otherwise, since equities become far more expensive when the market is optimistic. It is therefore necessary to maintain composure in order to make sound decisions even amid macroeconomic turbulence to identify exceptional businesses, invest in them, and wait for the storm to pass.

"Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold. When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons. And that we will do."

— Warren Buffett