Social Security Reform: The Day After

A new environment will require a new attitude from investors

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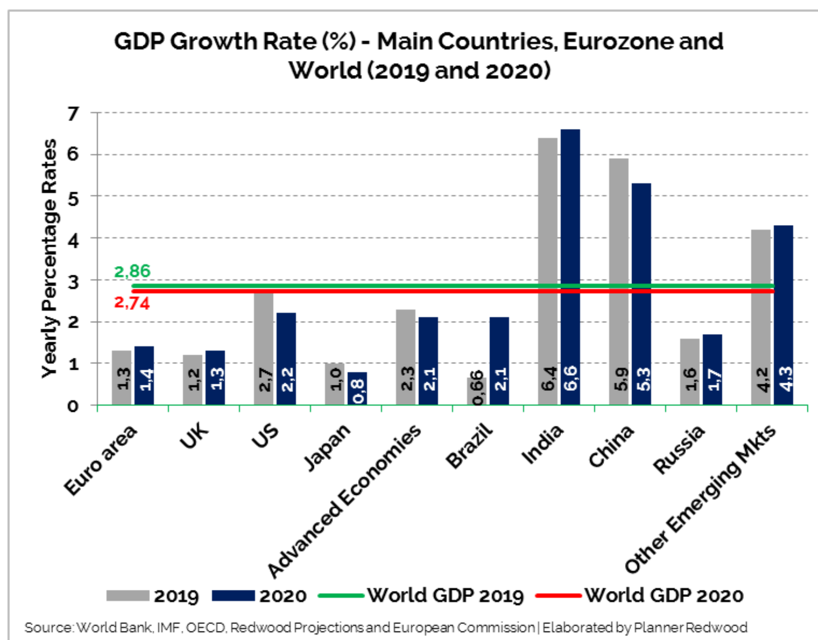
In recent years, Brazil has "flirted" every so often with the possibility of living with low interest rates, an idea however that never prospered for a number of reasons. Now, it seems pieces are falling into place so this can come to fruition, both for domestic and external reasons.

Internally, the political rough edges and the technical knowledge point to another profile, much more favorable than we had previously. The situation and the evidence for a better understanding of the country's dramatic situation have piled up - Brazil is broken economically and financially, as well as facing a crisis that has contaminated many aspects of our society and institutions. On the political side, although some important offenders remained in the house, there was a huge quantitative (and to some extent qualitative) renewal in Parliament. On the finance side, the size of our fiscal deficit (all levels of the Federation) leaves no doubt as to the griping bottleneck and its devastating impacts - to sum up, a stagnant economic activity with a contingent of more than 13 million people unemployed.



Overseas, the winds tend to also blow on our favor, if we manage to do our homework with the needed reforms, privatizations and modernization of our economy. In a world filled with certain Central Banks with a savior-complex in their homelands, there is now an enormous probability that we will see deliberate "joint" maneuvers by the major Central Banks in order to intervene massively in their economies. In Asia, the BoJ and PBoC will not shy away from repeating a new round of monetary policy easing, especially the latter, whose impacts of the trade war with the US has fueled this latter's interventionist bias. In Europe, the ECB presents itself as possibly the most "aggressive", at least when it comes to intervention: not only lower interest rates will pose as a remedy, but also some form of quantitative easing (QE) will appear, with new stimulus measures such as asset purchases; it's coming.

All this mess has a cause: the perception that the world can enter into recession and thus preemptive measures must be taken. The various prognoses actually point to a slowdown of some of the economies, but still far from a (demonstrably) significant shrinkage. What is more curious, however, is that the Fed may be leading the spread of this "recession" narrative. In a little over six months, the signal has changed from increasing its rates into various reductions, based on the perspective that the US economy will slow down sharply. Surely the Fed has a lot more "tools" to map out

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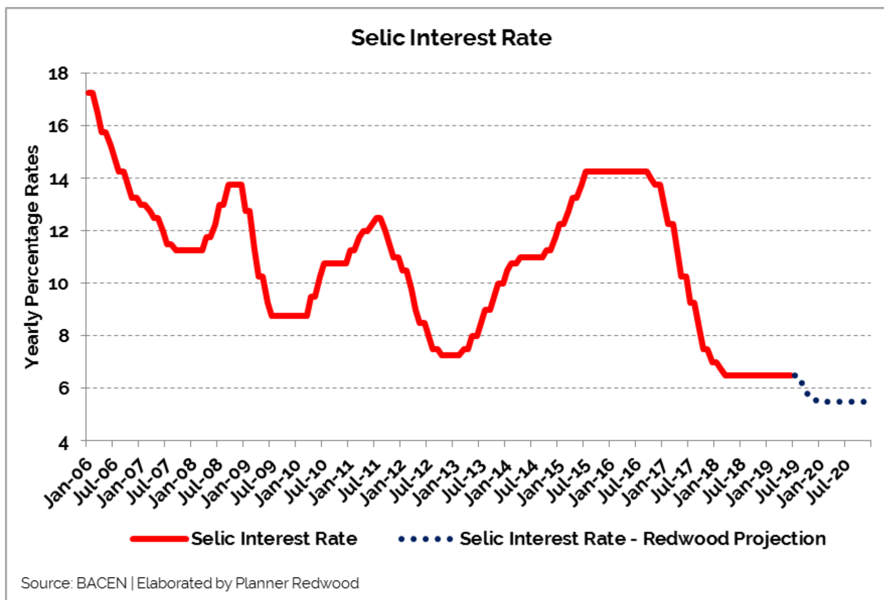
the future, but within reach of those who have their feet on the ground when it comes to available statistics and indicators, the credibility of this "new scenario" is questionable, to say the least... but the Fed has the power to "drag" other more unsuspecting policymakers along... a domino effect of Fed attitudes is not ruled out.

At any rate, should the world keep its distance from recession (this hypothesis could trigger a race for the Dollar) and also, with lower interest rates in its markets, world liquidity is bound to greatly increase. In this case, and having Brazil moved forward with its reforms, we will be a strong candidate to harbor a flood of resources in search of gorgeous returns. In this way, with our public accounts en route to balance, greater dynamism and openness of the economy, less regulated markets and better efficiency, we can have the long-awaited consolidation of a competitively healthy environment. In this line of reasoning, the yield curve will stay at very low levels, with reduced premiums and, in some cases, discouraging financial investments.

Under such a scenario and assuming a low likelihood of a major setback in the short run, the lives of investors in the financial market will get a bit more difficult. Actually, that's in fact so. In the wake of both internal (ongoing reforms) and external (central bank signals) forecasts, the financial market has already priced in a good part of this yield curve shift – thus impacting (albeit timidly) the exchange rate and the stock markets. In fact, fixed-income investors who have been in this market for the last 12 months, for example, in the long NTNBs maturities (2040/45/50/55), enjoyed average returns close to 50%, due to the drastic plunges of real interest rates - around 7.5 times the average CDI for the period.

This expected interest rate lowering by the Central Bank of Brazil (BACEN) to 5.5% from the current 6.5% until December of this year is therefore the crux of the matter for investors in this market. The expectation of what may come from the BACEN is already a reality in the financial markets, and for those who are not knowledgeable and/or not adept of arbitrations, risk-adjusted returns seem far from attractive. In fact, not at all, especially compared to the returns earned in recent months – the party is over!



Source: BACEN | Elaborated by Planner Redwood

From now on, accruing relevant returns will inevitably require investors to take in more risk. This means greater sophistication in the methodologies adopted, better understanding of economics and finance, and therefore resource reallocation among classes of assets. In other words, it will be hard to escape from taking more risks, but rather in a technical and qualified way, either in the macro or micro allocation of assets. If this sounds in anyway new to some Brazilian investors, it is no stranger to folks overseas, because in stable and structured economies, this form of action has prevailed for some time.

Thus, in a low-interest-rate environment, the investor (or someone with knowledge and competence

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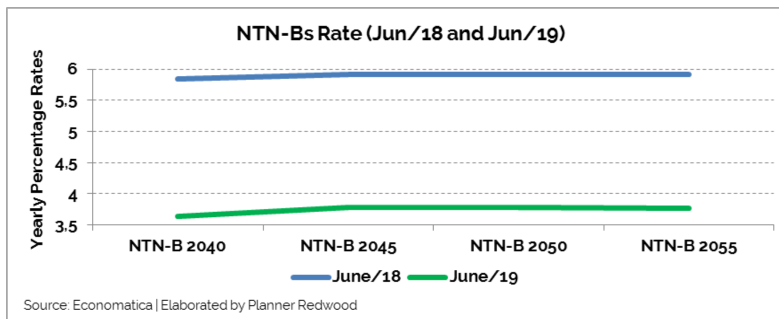
to assist) will have to use intelligence (including emotional) to clearly identify their goals, deadlines, risk propensities and willingness to hold on to a structured strategy. Obviously, a professional management to achieve the desired effect will also depend on the investor's bottom line understanding, otherwise the chances of discontinuity of investment outlines will be great – in the end, it is the investor that bears the losses.

However, in view of our history, assuming greater risks - regardless of the type of investor, individual or institutional, professional or not, with asset allocation favoring greater volatility, it presupposes besides continuous monitoring and clear and pre-defined management methodologies (hedging, exposure limits, liquidity, etc.), also progressivity in risk taking. This is what good planning must do, that is, take into account different scenarios. This is why macroeconomic understanding is central, and its interpretation should be properly identified and translated into finance.



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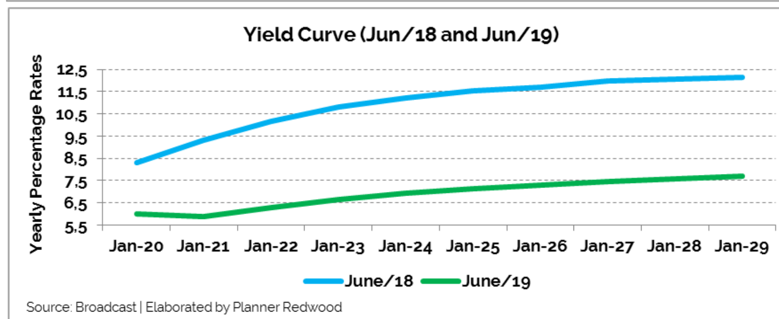

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The reversal of the current trend or even its non-consolidation cannot be excluded from an overall assessment of the new allocation mix. Clearly, the migration of part of resources currently allocated to fixed income may eventually be directed to stock markets, foreign investments, foreign exchange markets and/or via "more flexible" investment vehicles (multi-market, private equity, real estate and alternative funds etc.) – that is, asset classes that may present higher potential returns. However, even if it means less profitability in the new portfolio, having some liquidity at this moment is mandatory - yes, liquidity can be an important component of profitability.

Strictly speaking, the most appropriate title of this article should be Social Security Reform - The Year After, given that the consolidation of the most sustainable scenarios hinges on many variables. These latter (both domestic and foreign) will manifest themselves in the medium to the long term. The Social Security reform, for example, is only a cornerstone, a watershed - not a "silver bullet", but with great fiscal impact and amplitude - to stop the bleeding that has drained our public finance, and push us into a new economic-social-financial environment.

However, the financial market anticipates and factors in prices (of assets) all of these movements - political, economic, financial, etc. - whether they materialize or not. The dynamics and efficiency of the markets will also evolve - there will be no room left except for those bearing qualifications and good techniques.

It will be up to the investor to further his/her education on these matters (including the help of professionals, at the cost of assuming asymmetric risks) in order to face this likely new environment, thus avoiding frustrations and managing to make the best of the situation. These are good news. Anything other than this is bound to discourage investors.

Good riddance and good investments!

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