MAY - 2020

MONTHLY STATEMENT

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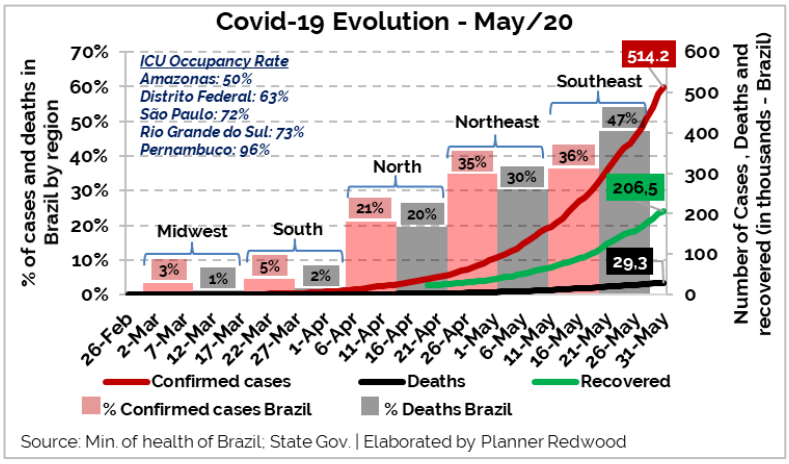
"The function of economic forecasting is to make astrology look respectable"

John Kenneth Galbraith – American Economist and Philosopher

The Covid-19 death toll in Brazil has reached 30 thousand. Meanwhile, the triple alliance of crises (health, economic and political) is advancing unfettered, under the auspices of our leaders and to the shivers and aggravation of the Brazilian people. Institutions struggle with one another. Justice has never been so "blind", the Legislative branch advances with its lines in fiscal bombs, and the Executive, under the Commander in Chief, fails miserably to display any whisper of leadership. A sad moment in our history, which could have been used as an opportunity to make us more united and stronger, but which daily feeds back on itself and pushes us towards an outcome that, without a change in course, the three crises turns into social chaos.

The false dilemma between lives and livelihood does not seem to have been understood until now. Between the lockdown (supposedly total life protection) and no mobility restrictions (supposedly a functioning economy), we were unable to move with an adequate and efficient plan for each situation, given the heterogeneity of each city and state. We lack a unified plan and guideline (*Covid-19 and GDP: a Life and Death Trade-off*), but one that fits each branch and level of the federation. There is no single protocol for the proper cooperation, collaboration and communication between States and the Union - regardless of the due autonomy of States and Municipalities. This detachment promotes disorientation and, despite our best intentions and atomized plans, throws us into the ground of the imponderable process of trial and error.



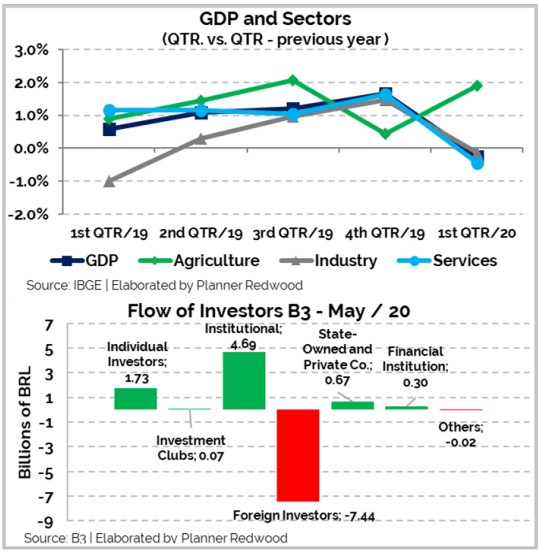
Source: Min. of health of Brazil; State Gov. | Elaborated by Planner Redwood

The stark truth is that GDP will collapse, given the way we have reacted so far, especially in relation to the rest of the world (including the USA, a sort of "mirror image" for Bolsonaro). However, the reopening of the economy will be much worse if done prematurely, that is, under insufficient conditions that do not preclude the upswing of contagion to even higher levels. This means that, in such a hypothesis, we would have to return to the restrictions on mobility, making our economic recovery even more painful. Our economic situation was already showing signs of less exuberance at the beginning of this outbreak, but current conditions are profoundly aggravated. We cannot go wrong now, neither in resuming the conservative agenda once we get rid of the Coronavirus.

We very much want to go back dreaming of economic growth and job and income creation that was emerging, albeit timidly, in our scenarios. However, we are not between *Free to Choose* (book and TV series by Milton Friedman/1980 that promotes free market principles - which we want!) and *Courage to Act* (book by Ben Bernanke/2015 - memories of the 2008 crisis when he chaired a sharply intervening FED); definitely not! We are faced with an *obligation* by the State to act (and act strongly!) Not because of the similarity with the 2008 crisis, but because of its imposition and the restriction of economic activities (necessary in epidemiological terms).

There is no more time to lose in facing these multiple crises. Time is not on our side; in fact, it only magnifies its effects. However, while the forecasts, especially the economic ones, are difficult to get right in a normal situation, it does not seem very challenging to point out the direction of our economy in this context. What a shame! And yes, astrology is respectable in comparison!

The financial market over the past two months has shown "exceptional" profitability compared to the performance of the economy. Does it make any sense? Yes. Financial markets always look ahead in an attempt to understand what is to come. It anticipates movements and prices them, almost as a rule and, in times of greater stress, it overreacts. This happens continuously and, when you have a better understanding of the scenarios, prices can be corrected and with an overreaction too. The fact is that, in the long run, this detachment from "reality" and volatility itself tend to decrease. Thus, the Ibovespa rose 8.57% in May, further reducing the annual drop to -24.42%. Interest rates movement led to smaller fluctuations in vertices in May compared to April, with the difference between the maximum and the minimum situated between 0.535 and 1.19 points for DI1F21 and DI1F25, respectively. DI1F21 ended the month at 2.30%, practically at its 2.29% low, and DI1F25 was cut to 5.97%. The Brazil risk, measured by the 5-year CDS, followed the same path, and fell to 286.18 points, a reduction of more than 20 points that may have influenced the slowdown of the Dollar's rise (Ptax), which ended the month to BRL 5.426 - practically the same value of April BRL 5.427 - but reaching a maximum of BRL 5.969.

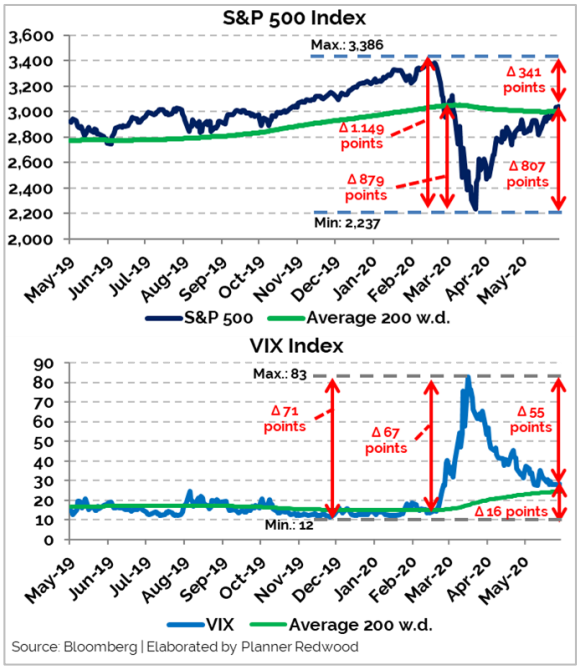


The real side of the economy showed in the figures for the Q1 (-1.5%), with only part of the effects of Covid-19, which is to come notably in the Q2. It will be a disaster, something like -10%, but it is expected to reach rock bottom. Long-term predictions are pure wishful thinking, because in fact we will fundamentally depend on the evolution of the disease or even on the development of a vaccine and, of course, on the consistent reopening of the economy, among others. However, adjusting our probability hypotheses, the scenario we deem the most adverse gains ground, wherein the economy's performance shrinks around 7%. Under this hypothesis, the unemployment rate would advance to the average of 15.5% by Dec/20.

Promises of fiscal discipline, a trademark of the government under the guidance of Paulo Guedes, are monitored with a magnifying glass. The profound impact of the triple crisis imposed the archiving, albeit momentary, of the reformist agenda. Foreign investors leave the stock and bond markets of Brazil massively (but there was a countermovement in terms of Brazilians who started looking for higher income assets), fearing uncontrolled public finances. Not least, with a darker scenario for this year's GDP and a protracting end to the crisis, additional measures of protection and/or extension of the emergency benefits, with serious prospects of perpetuating them (basic income), are definitely on the radar. The size of this bill is yet unknown, but it is estimated that with the drop in GDP and significant increases in spending, we will easily reach 100% in the Gross Public Debt/GDP ratio. The real feasibility of paying this bill is quite scary, at the time when our only fiscal anchor, the Expenditure Cap, is cornered. This social agenda, just in view of the certainty that we will emerge poorer from this crisis, will be addressed by the Executive or the Legislative branches - all the better if led by the Executive, so as to coordinate within the realms of what is "possible" (a transition to sustainable levels in public finances), glimpsing, jointly, which may come from the reforms ahead. This uncertainty alienates foreign investors. It is the cost of not having done our homework (reforms) ... we will pay a high price!

Although Brazil has relegated fundamental reforms on the umpteenth level for years (in the current government, progress has been made exclusively in Social Security), monetary policy, in turn, has delivered what it proposes at least, notably through BACEN's single mandate. Inflation is "under control" and we have interest rates at the historic low, with very important effects for the economy. But is this entirely the monetary authority's doing? To a large extent, yes, but the reflexes of reduced aggregate demand have a significant impact on price

levels. In any case, this is a good direction, and above all reasonably transparent, which makes us believe in BACEN's signals (not necessarily what we think it should do): it will lower the SELIC again. The new cut will depend fundamentally on inflation expectations for this year and the next, both below the target - even with the likely impacts of the exchange rate (pass-through). In fact, when it comes to exchange rate policy, the situation is embarrassing when the BACEN is asked about it. Now it is said that it interferes when a liquidity gap is detected ... it has improved, as they no longer talk about trying to control volatility. Anyway, it is good that the exchange rate is "fluctuating" and, at this moment with this depreciation, the commodities and agriculture sector are grateful, because in addition to having high productivity by competence, they see their results (exports) leveraged by the greater competitiveness boosted by a devalued currency. However, with the cooling of the triple crisis we are under, its effects on the exchange rate will be mitigated and, continuing with the "floating" exchange rate, we will have lower Dollar quotes soon.



In finance, therefore, given the above understandings, we can see theoretically counterintuitive movements (in W-shaped), with "exuberance" in the financial markets *vis-à-vis* the economy, with price recovery (dropped a lot) favored, even, by foreign markets, and less impact of political risk in the short term. More representative indicators of an economy (such as the S&P 500), are also subject to movements of this nature, mainly due to the action of the FED in drenching the system in liquidity. In fact, this bail-out of the economy to mitigate the effects of the crisis, even in the short run, the market would react in time for the recovery of the economy. It is not for any economy/country, just look at the recovery outcome from the 2008 crisis and its successive Quantitative Easing and other required instruments ... some countries do default!

Another way of looking at this "phenomenon", still under the eternal tenet that savings should equal investments (S = I, discussed several times here), in progress in the USA and perhaps *applicable* in Brazil, would be through the Kalecki profit equation, which translates corporate profit (CP). In aggregate, CP is a function of Investments (I) + Dividends (D) – Household Savings (HS) – Govt. Savings (GS) – Foreign Savings (FS). Thus, (I + D) will plummet, HS will increase, FS (understood as the inverse of the current account deficit); and GS will be a government deficit of approximately USD 4 Trillion! ... as huge as the expected downswing. With the Americans' low propensity to save, the S&P 500 "has already priced" the recovery of corporate profits ahead. Has it really? Is government spending enough? No ... but it helps the economy and the financial system in the short run ... S&P 500 recouped 70% of its recent high and 92% of its 200-day average. This is undisputed, as we have seen here. However, a permanent breakdown in our public finances will bring the specter of insolvency to our public debt and, as a result, we can say farewell to fundamental foreign savings!

Overseas, countries in Europe, China and the USA are beginning their transition to a "new normal". In all of them there are still fears of a second wave, but they consider economic reopening to be appropriate and timely. China comes with a new round of stimulus, providing USD 56 billion for purchases of "qualified debt" for small and medium-sized companies. However, the unequivocal finding is that countries will take care of themselves. Dependency on China opened up this fragility. Consequence: globalization as we know it is also in check. It remains to be seen how it will play out.

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