BRAZIL:
Lower rates for longer in Latam.

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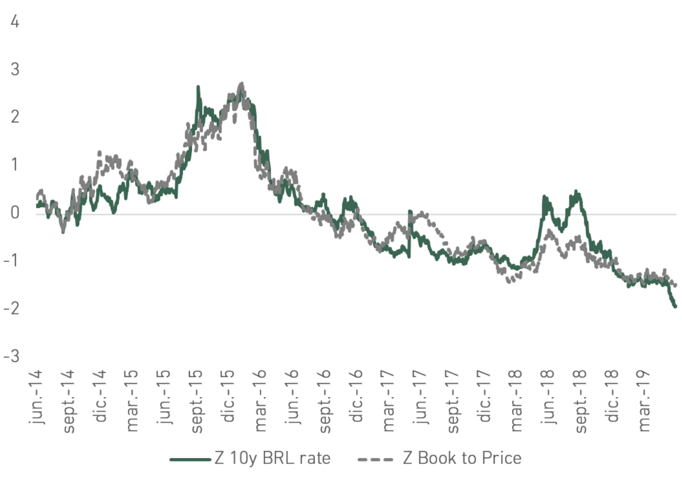
Yesterday the FED held interest rates but shifted their speech towards a more dovish stance, pointing to possible interest rate cuts in the near future. The argument was the rising uncertainties about the economic global and local outlook. In the same line, the Chilean and Brazilian Central bank follow this trend. In Chile the central bank reduced 50 bps the interchange rate to 2.5%. The Copom in Brazil kept rates at 6.5% but also presented a dovish speech.

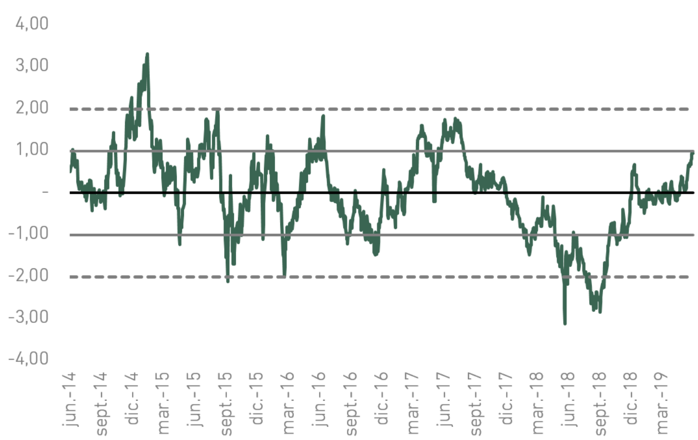
Long term rates followed these movements. The US 10-year rate is below 2%, its lowest level since 2016. But the Brazilian case is remarkable. Now the 10-year rate in Brazil is at 7.8% at historical lower levels. Both nominal and real rates are at the bare minimum. The good news is that not only global rates are being supportive, but also the political situation is helping. The pension reform is going on track and even though its constantly generating noise, the public and political acceptance has increase dramatically in the past 3 years. We believe it's going to be approved and this should drive long term rates even lower from a structural point of view for Brazil (from a "macro compensation" point of view). And this should continue supporting convergence towards low rates.

There are two good news for equities here. First, there is a decouple between rates and valuation. In the next chart you can see the strong correlation between long term rates in Brazil and valuation. The good news is that there is a decoupling right now. So just assuming current rate levels are sustainable, there is an almost 10% of upside in Brazilian equities coming only from this long term historical relation.

Long term rates vs Book to Price in Brazil Normalized.



Standarized Residual of valuation explained by rates.



The second good news comes from flows. Remember the historical lows for real rates in Brazil? Well pension funds and mutual funds are not indifferent to this. Both are below the 10-year average in terms of exposure to Brazilian equities and in plain words just by getting to average (in an historically low rate scenario) there should be an inflow of about 5% of the Bovespa market cap.

Our thesis remains the same. GDP growth expectations have been dropping throughout the year but EPS growth expectations continue on track. Operational leverage and low capacity utilization are the main drivers for this anomaly. We have been positive in Brazil for the past three years. We believe that the pension reform is going to be approved and that should bring lower discount rates, higher foreign investment and the long awaited recovery. We are playing this call mainly through companies that are sensible to rates and high growth stories.

Last, looking at style of investment, we still favor Small against Large cap. Even though in a short term large caps should outperform in our base case mainly due to flows coming back, we believe that small cap companies are going the be the most benefited in this scenario and are still trading at a discount.

Cumulative spread return of Small Cap vs Large Cap Brazil