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RIO BRAVO
STRATEGIES

THE BEGINNING OF THE END

JUNE 2018

Several factors point towards the end of an administration, and the most prosaic are the promptness of waiters and whether they're still serving hot coffee or not. But there are many others, such as populist voting and, above all else, in times of World Cup and stalled voting, court rulings against the federal government favoring functionalism. The last 30 days of this chapter have been spectacular."

BEGINNING OF THE END

The Senate voted on a provisional measure in late May (817/18), by Senator Romero Jucá (MDB-RR), which included about 4,400 employees under the framework of the Federal Government from the former territories of Roraima, Rondônia and Amapá. The estimated fiscal cost exceeds BRL 3 billion per year. The Superior Labor Court (TST) ruled against Petrobras on account of excessively benevolent interpretations of wage benefits calculations, with an approximate cost of a whopping BRL 17 billion. The courts ruled against Serpro as well, including some agreements in the Labor Court, under which approximately 500 employees won around BRL 250 million.

On June 27, justice Ricardo Lewandowski granted an injunction that prohibits privatization without an authorizing law, claiming that "there has been, in fact, a growing wave of privatizations taking shape across all levels of the country. If executed without strict observance of the provisions of the Constitution, this may cause irreparable damages to the country". The day before, Lewandowski was part of a majority in the second chamber of the Supreme Federal Court (STF) that ordered the release of José Dirceu and others imprisoned after being convicted by a court of appeals in the Car Wash operation. Finally, the Legislative Assembly of Rio de Janeiro passed a 5% raise on June 28 for justice officials and the State Prosecutor's Office, groups whose salaries were not adjusted during the state's crisis period, despite opposition from the governor.

These pearls intertwine with the all-star team and the excitement of the World Cup, framing a scary picture of a government disintegrating before our very eyes. The financial markets take the blow, but react idiosyncratically. For the first time in many years, a *circuit breaker* tripped in interest derivatives on the 7th, amid rumors of an extraordinary COPOM meeting and the U.S. dollar approaching BRL 4.00. The Central Bank of Brazil (BC) was severely tested on that difficult day, when it held a press conference at close of business to announce more aggressive operations in foreign exchange *swaps* and repo agreements.

> “ Financial markets take the blow, but react idiosyncratically.

The market has yet to have swerve since then, but everyone is on edge.

The inventory of foreign exchange swaps jumped from USD 30.3 billion to USD 67.4 billion between the 7th and the end of the month, and two auctions (spot U.S. dollar sales with repurchase) were held for a total of USD 3 billion. Not only was no extraordinary COPOM meeting held, but in the ordinary meeting on June 20, the committee didn't change the Selic rate, and reaffirmed

BEGINNING OF THE END

the institution's commitment to the IPCA target, the economy and the "balance of risks". The exchange rate uproar can clearly affect whether the target is attained: when new exchange rate scenarios are entered, the BC's own models indicate higher inflation this year at 4.2%, although lower next year at 3.7%, but in a market scenario (with the Selic rising to 8% and the U.S. dollar at BRL 3.63). With no increase in interest rates and the exchange rate at BRL 3.7, the model would estimate 2019 inflation at 4.1%.

> " The BC's own models indicate higher inflation this year

There is nothing new to report on the electoral front. Polls continue to show Lula or Jair Bolsonaro in the lead, but with Marina Silva in second place (13%), well above Ciro Gomes and Geraldo Alckmin, technically tied at 8% to 6%, respectively. The World Cup continues to create a thick fog that clouds the population's interest in electoral affairs. Party conventions in early August will better define the October ballots, both by scrubbing the presidential race and defining regional disputes and party alliances.

In the mean time, the fallout from the truckers' strike that gave those responsible for economic and inflation forecasts a good scare is being diluted. The Ministry of Finance estimates a direct impact of 0.2 p.p. of the GDP, but does not address indirect effects. We estimate an impact of 0.5 p.p. and others who are more pessimistic forecast a loss of up to 1 p.p. Economic data has yet to capture the event, but leading indicators suggest production of over 10% in the month. Inflation measured by the IPCA-15 in June stood at 1.11% (up from 2.7% to 3.28% in the past 12 months) and the closed IPCA should be around 1.3%.

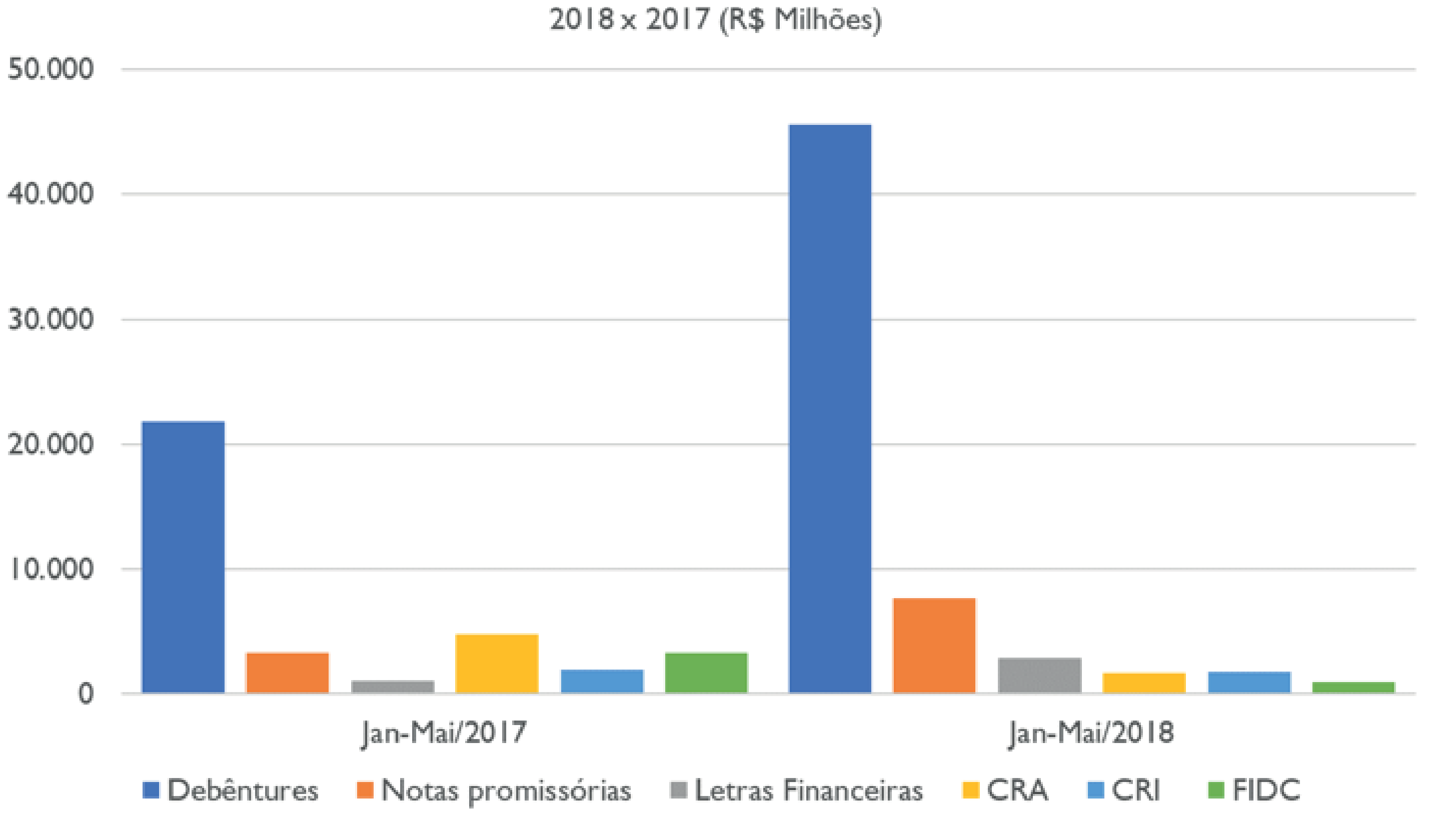
From here on out, once the World Cup is over and regardless of the result, electoral tensions should grow exponentially.

> " The political establishment doesn't buy the idea that the long-awaited political renewal will change the dynamics of Congress

It's a short campaign with a highly unpredictable outcome. The political establishment doesn't buy the idea that the long-awaited political renewal will substantially change the dynamics of Congress, hence the logic of coalition presidentialism.

But nobody is sure. There will be new faces in the Parliament, but perhaps less than the country would like. Along those lines, two distinguished and experienced senators happily debated in the plenary not on whether they would be present in the next parliament, but on whether they would be in the incumbent party or the opposition.

Fixed income funds (Debentures, Promissory Notes, Real Estate Receivable Credits (CRIs), Agricultural Receivable Credits (CRAs) and Investment Funds in Credit Rights (FDICS)) via domestic capital markets totaled BRL 60.5 billion from January through May 2018, amounting to a 67.3% increase when compared to the same period in 2017. The issuance of debentures representing BRL 45.6 billion in total funding stands out.

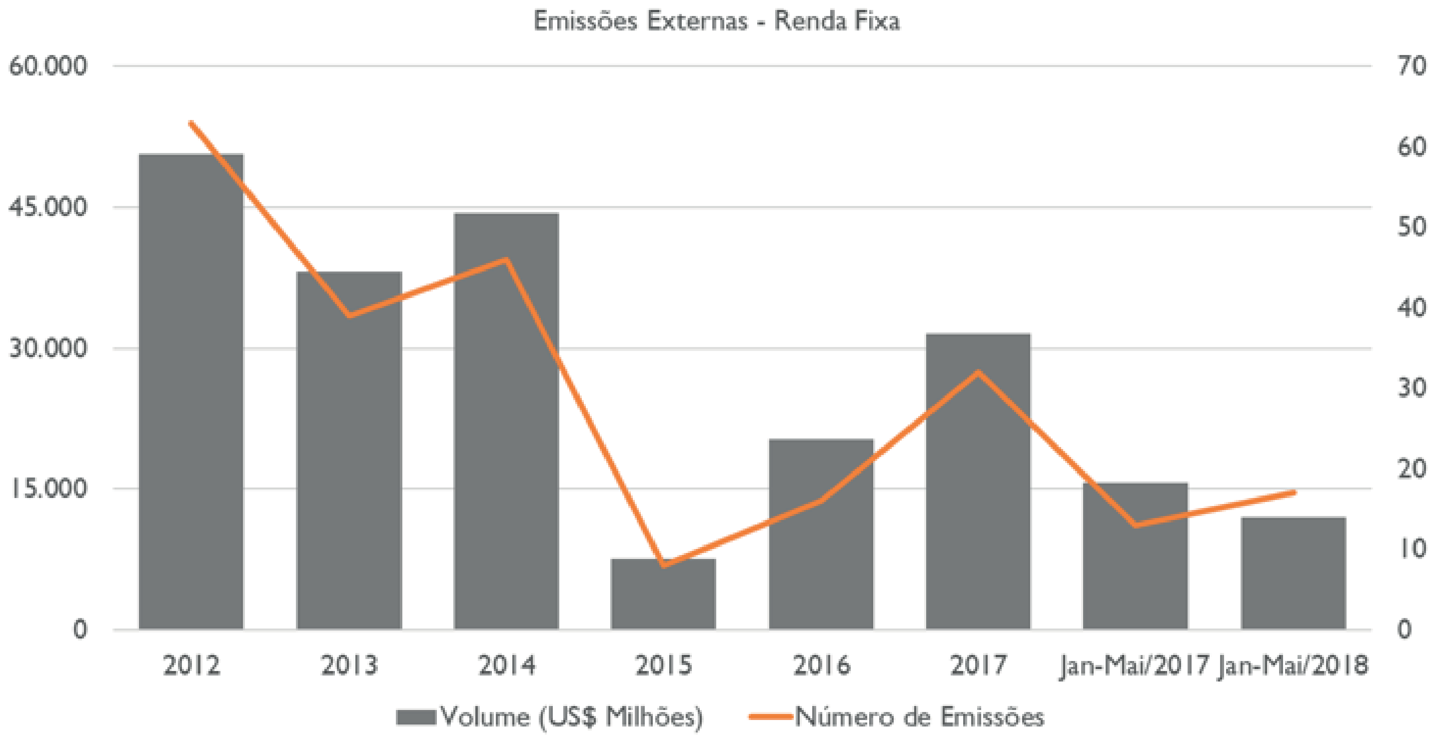


The deteriorating macro and political scenario experienced in the month of May lingered throughout June. The volatile exchange rate joined forces with the increase in U.S. interest rates and contributed to capital flight from emerging countries. At the same time, foreign funding costs rose for domestic companies.

Unigel was the last company to access the foreign market, a chemical company that raised USD 200 MM on a six-year bond with a 10.5% yield. No issuances were announced in June.

A total of 17 foreign issuances were made during the period from January to May 2018, totaling USD 11.95 billion, down from USD 15.65 billion in the same period of the previous year, when 13 issuances were made.

FIXED INCOME



Companies intending to raise funds on the local market in the coming weeks include Aegea (AAA Rating, BRL 600 MM, divided into a five- and seven-year series), Copasa (AA Rating, BRL 700 MM, divided into three-, five-, and seven-year series), Restoque (A- Rating, BRL 225 MM in a single series), MRV (AA- Rating, BRL 770 MM divided into five- and seven-year series). Besides those mentioned, Taesa is accessing the market by issuing tax-free infrastructure debentures and Contour Global is funding through Investment Funds in Credit Rights (FIDC).

Closing of the first six months: how did IFIX behave?

Real estate funds experienced extremely distinct moments in the first half of 2018. After a strong resumption in the past two years, with returns of 32.3% in 2016 and 19.4% in 2017, the IFIX has already climbed 5.5% between January and May 2018. The strong profitability of the FIIs made room for new issuances of shares that began to enter the market. In the first half of the year alone, 25 new issuances were registered in the CVM, totaling BRL 7.8 billion in Real Estate Fund shares. The scenario was such that the demand for this type of product could no longer be supported by the Funds' current inventory and a good part of this profitability was the result of better fundamentals for the housing market. The vacancy rate for Triple A corporate offices, which reached heights of 25% in mid-2015, closed the first half of the year at 16.8%. The drop in the vacancy rate is emblematic for homeowners, since it ensures less supply and consequently less competition, giving the owners power to bargain renegotiate leases with their tenants. We also saw a significant improvement in the logistics industry. Accompanying the global structural change, which is increasingly involving more online shopping, logistics FIIs performed very well in 2017 and began 2018 on the same track. People's consumption habits via the internet should require increasingly complex logistics, which are necessary for e-commerce companies and will demand more spaces for this type of product. However, this scenario with strong fundamentals suffered a hiccup in the past two months. The FIIs fell 9.1% on average, reversing the upward trend and closing the first half of 2018 with a 4.5% drop. This fall is related to a single factor: the Brazilian interest curve pricing. Due to recent events related to the Brazilian and global macro scenarios, which involved increased U.S. interest rates and concerns on the fiscal and electoral situation in Brazil, investors began to price a significant increase in the interest rate. The IPCA+ Treasury premium (formerly NTN-B), which came close to 5% p.a., climbed to close to 6% p.a. As a result, the Real Estate Funds ended up being priced at a higher discount rate, and their shares lost value. Nevertheless, the FIIs still have interesting profitability in a 24-month window of close to 14% p.a. The improvement in the real estate fundamentals and the supply and demand relationship for property shouldn't deteriorate

REAL ESTATE INVESTMENTS

as fast as the interest curve. That's because real estate investments are long term by nature, which means that significant structural changes in these fundamentals take some time. Therefore, the investor needs pay attention and take advantage of the opportunities that arise in the FII market. Since the FIIs are highly correlated with the IPCA+ Treasury premium, this high interest rate volatility, which is reactive to various news stories and short-term movements, could produce buying opportunities for investments in FIIs, which are long term by nature and where purchase prices are fundamental for a consistent return over time.

The markets followed their behavior of the previous month in June and we thus observed an intensification in losses and an additional boost to volatilities in several domestic asset classes.

The Central Bank of Brazil's (BC) monetary policy sits right at the center of the scenarios created by market agents. COPOM announced on June 20 its intention to maintain the Selic base rate at 6.50%, corroborating the expectations of most institutions and their economists. The statement from the Central Bank and the minutes of the meeting shed little light on the future interest rate trajectory, but there is a strong emphasis on monitoring future inflation expectations. Also in June, the National Monetary Council (CMN) announced the reduction of the 2021 inflation target to 3.75% over 4.00% in 2020.

The economy's base interest rate in the United States (Fed Fund Rate) was raised 0.25%, now reaching the range of 1.75% - 2.00% with two more potential hikes in 2018 for a total of four in the year. In another moment of the cycle, the European Central Bank announced a reduction to the asset purchase program starting in October, with complete closure at the end of the year.

The local interest market experienced another period of opening rates, which was most intense in mid-June, but yielding especially after the COPOM announcement.

Both the real and nominal interest markets closed the month with losses, which were more intense in the longer maturities (IMA-B – 0.32%).

June also marked the rise of the U.S. dollar (+4.11%), which flirted with a high of BRL 4.00. After reaching its maximum on June 7, the Central Bank came into the light and managed to cool things down by announcing an increase in exchange rate swap volume and making clear indications that it does not intend to use monetary policy (notably, the Selic rate) to control the exchange rate. The exchange rate has been operating at a more well-behaved level since then, although the rate returned to BRL 3.80 last week.

The domestic stock exchange played suit to the scenario of uncertainty, volatility and prospects of higher interest rates in the United States and recorded a significant drop in June (-5.20%).

DIRECT ASSET MANAGEMENT

It was a rough month for multimarket funds, having suffered more specifically with the FII and interest structural positions. Confidence in our interest rate scenario, however, led to a strong recovery from the drawdown in the second half of June. The slope of the interest rate curve is still the fund's best bet via FRAs 2019 and 2020, with less allocation in FRA 2021. The two top positions also rely on swap structures for their protection, with gains of over 80bps repressed by their.

MULTI-ASSETS & PORTFOLIOS

respective current prices.

We are structurally divested in equity and foreign exchange, searching for market opportunities to assume a tactical position, while the event-driven cash flow, which suffered with the FII performance in the secondary market, is currently at an appropriate size for our risk (< 9% NW, FII 5.5% NW). The class distortions due to market inefficiency intensified movement in the period, but offered short-term opportunities on the other hand that add value to the portfolio, as was the case of ABCP11 (gain of 3.5% in two days).

The positive highlight for the month was our quantitative allocation, which generated 18bps in less than 7.5% NW allocated, in addition to lowering the portfolio's overall risk given the decorrelation to other strategies. We increased exposure to 10% NW at the turn of the month, the maximum level we consider appropriate for the fund.

The overall result of the Rio Bravo Apollo FIC FIM was -0.48% in another negative month for the so-called Brazil Kit. It has now recorded positive results in 16 of its 18 months of management, 14 of which were above the CDI.

PORTFOLIO ALLOCATION

The aforementioned context caused significant impacts on both portfolios and our perception of risk and return in different asset funds recorded results below the CDI on average, and many funds ended the month with negative results. We reduced our exposure to these funds slightly, maintaining liquidity resources. This shift is part of a reduction in risk performed on the portfolios to face the coming months until the elections.

Stock market funds were the hardest hit over the period, in line with Ibovespa's performance. It is important to note that many managers were able to successfully defend their portfolios with a careful mix of stocks that, despite negative results, managed to outperform Ibovespa. Although we have low allocation in stock funds, we decided to reduce it by half on average, in line with the increased aversion to risk.

The Real Estate Funds market (FIIs) also recorded losses in the month, with the IFIX dropping
-4.01%. This movement was not accompanied, on average, by the behavior of rentals and asset prices that support the funds, which leads us to believe in a reaction must more strongly tied to prospects for future interest rates and aversion to risk than the real estate market itself.

classes until the end of 2018. Multimarket

PERFORMANCE (%)

	Rio Bravo Crédito Privado FIRF	Rio Bravo Liquidez DI FI Referenciado	Rio Bravo Fundamental FIA	Rio Bravo Apollo FIC FIM	Rio Bravo Portfólio Diversificado I FIC	Rio Bravo Portfolio Diversificado II	Rio Bravo Portfolio Diversificado Internacional	Rio Bravo Portfolio Diversificado Equities FIC FIA	Rio Bravo Juros FIC FIM	Rio Bravo Previdencia FIM	Rio Bravo Columbia Threadneedle FIM	Rio Bravo Pandas FIC FIM	CDI	Ibovespa	SMLL	Euro	U.S.	FTSE BRL (ex-	IMA - B	IFIX
June 18	0.51	0.44	-4.77	-0.48	-0.27	0.32	2.24	-3.75	0.82	-1.79	3.40	1.90	0.52	-5.20	-3.66	4.22	4.11	3.29	-0.32	-4.01
May 18	0.52	0.44	-9.56	-2.12	-1.21	-1.12	4.49	-6.22	-2.41	-5.95	5.83	1.88	0.52	-10.87	-11.31	2.70	6.21	0.98	-3.16	-5.27
April 18	0.52	0.45	-5.30	0.02	0.30	0.16	6.54	0.15	0.08	-0.51	3.92	-0.99	0.52	0.88	2.37	4.08	6.05	6.83	-0.14	-0.86
March 18	0.54	0.47	0.34	1.79	1.25	0.56	0.34	0.32	2.33	-0.36	2.62	2.13	0.53	0.01	0.07	2.66	1.81	-0.31	0.94	2.00
February 18	0.50	0.41	-3.65	1.08	0.54	0.42	-0.66	-1.67	1.26	0.25	-3.16	2.40	0.47	0.52	-0.37	0.13	1.88	-3.47	0.55	1.15
January 18	0.62	0.54	7.98	0.69	1.17	1.87	-2.91	7.06	0.97	3.84	0.70	2.07	0.61	11.14	4.34	-0.11	-3.78	2.30	3.43	2.64
December 17	0.54	0.48	4.90	1.00	1.06	1.00	0.91	4.59	1.42	1.62	1.02	3.36	0.54	6.16	7.03	1.85	1.36	1.56	0.80	0.60
November 17	0.58	0.50	-3.13	0.58	0.30	0.31	-0.26	-3.02	0.49	-0.82	0.99	1.21	0.57	-3.15	-2.43	2.04	-0.10	0.02	-0.76	-0.59
October 17	0.64	0.59	0.55	0.67	1.23	0.29	3.56	-0.55	0.26	0.44	5.25	1.96	0.65	0.02	-1.48	1.99	3.44	4.12	-0.38	0.23
September 17	0.64	0.58	3.46	1.65	1.34	1.46	0.72	3.64	1.63	2.04	2.98	1.72	0.64	4.88	3.68	-0.37	0.43	3.54	1.81	6.58
August 17	0.80	0.75	5.54	0.88	1.17	1.10	1.64	5.20	1.19	2.76	0.75	0.29	0.80	7.46	8.55	1.33	0.76	0.87	1.34	0.86
July 17	0.84	0.75	3.85	0.90	0.88	1.47	-4.54	3.79	2.25	3.51	-2.50	1.05	0.80	4.80	8.14	-2.11	-5.53	-2.23	4.00	-0.38
June 17	0.99	0.78	0.73	1.06	0.97	0.79	1.54	0.92	0.18	-0.64	1.17	0.20	0.81	0.30	0.39	4.21	2.52	0.88	0.16	0.85
Yea	3.22	2.77	-14.85	0.94	1.79	2.23	10.41	-4.54	3.00	-4.72	14.02	9.71	3.18	-4.76	-9.00	13.87	17.04	9.34	1.16	-4.55
r 12	7.47	6.58	-1.34	6.80	8.03	8.13	12.20	8.99	10.67	4.69	23.85	20.64	7.37	15.68	13.93	19.82	17.19	18.46	8.20	2.46
months	22.27	19.84	4.14	-	25.13	22.36	12.59	31.57	24.05	16.80	49.42	33.30	21.37	47.75	58.08	21.08	14.27	-	21.49	30.43
24 months	39.59	35.78	5.74	-	39.34	38.25	27.97	33.82	40.55	29.15	-	-	38.26	37.08	49.17	31.06	24.94	-	43.12	45.52
36 months	56.11	50.98	-5.00	-	-	51.72	65.06	24.98	56.08	30.05	-	-	54.45	37.21	21.01	49.15	74.35	-	62.01	52.83
48	175.63	173.26	431.98	13.70	49.36	180.60	66.00	32.21	109.26	32.14	21.44	40.09								
months From	404,853	7,485	8,344	66,215	74,007	11,161	4,267	6,589	19,369	12,590	41,991	4,343								
the beginning																				
Current NAV (in Inception date BRL thousands)	08/14/08	12/28/07	09/08/04	01/04/17	10/09/14	11/03/08	12/11/13	04/16/12	04/08/11	03/12/13	09/29/15	08/17/15								
Administration fee (p.a.)	0.45%	0.35%	2.00%	1.50%	0.40%	0.60%	1.75%	0.70%	0.85%	1.10%	0.08%	0.90%								
Performance Fee (p.a.)	-	-	20% over the IBOVESP ^	20% over the CDI	-	10% over the CDI	-	None	10% over the CDI	-	-	25% over the CDI								

¹ Maximum administration fee, including administration fees of invested funds: 0.50% p.a.
² Maximum administration fee, including administration fees of invested funds: 1.10% p.a

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