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STRATEGIES
RIO BRAVO

A LEADERSHIP CRISIS

MAY 2018

Economic recovery had been sluggish and losing momentum, perhaps affected by political uncertainty over the upcoming elections, until the foreign exchange market came under some stress early in the month – which could be plausibly associated to the dollar's movements in the global market.
However, one could reasonably ask whether the international markets were signaling some concerns about Brazil's political future. Was the market finally expressing its uneasiness with an election that is shaping up to be highly polarized between candidates such as Ciro Gomes and Jair Bolsonaro?
Should the Central Bank of Brazil (BCB) meddle with the currency in order to keep its value from plunging, which could have some impact on inflation? →

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As we know, there is an unsolvable identification problem when it comes to defining the best theory on what makes the exchange rate fluctuate. In theory, the Central Bank shouldn't have to step in and try to put out a fire started by the candidates' boisterous speeches. But there is no denying that the BCB interrupted the downward trend in interest rates and assumed a more active role in the foreign exchange market.

The truckers' crisis erupted as the latest element in a formidable combination of mistakes and bad luck – one of those situations that markets are unable to predict, but where the postmortem seems less complex than reality.

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The losses were massive and involved lost goods, property damage, rioting, injuries (and at least one death), tax waivers, excessive concessions, losses in growth and diminished political credibility, the latter being a powerful reminder that, as in finance, there is no "rock bottom" in politics (it can always get worse).

It is not easy to determine what started this situation, since that involves an implicit assignment of blame; however, it would be fair to say that ground zero for the crisis was the "Petrolão" graft scandal, which left Petrobras on the brink of insolvency. The new administration has reversed some of the populist tax policies of the previous governments, but benefitted from setting oil at prices above the so-called "international levels" for quite some time – leading to a widely acclaimed bounce-back in revenues.

Meanwhile, derivative imports grew stronger than previously expected, especially since Petrobras accounts for a significant portion of the import infrastructure. In fact, its increased share in the import market is what made the company bring its prices closer to international levels, including the ability to make quicker price adjustments, in order to meet the challenge posed by foreign competitors.

The new arrangement seemed to work out well enough and started to resemble the system in place in the U.S., which, in theory, brings international market volatility to the pumps. The country had already moved away from European derivative pricing systems when former president Dilma Rousseff changed the regulatory nature of the CIDE tax and decided to share its revenues with states and municipalities.

The absence of a buffer to protect consumers from absorbing all the volatility of oil prices wasn't a problem when prices were on a downward slide. In hindsight, however, it was not the best system to handle an international price shock, such as the one we've witnessed since the middle of last year.

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There are other storylines for the crisis, such as an overburdened transportation sector, which relies heavily on subsidies aimed at the purchase and manufacturing of trucks, and the fiscal crisis, which led to the government raising the tax rates for PIS-COFINS (Social Integration/Social Security Financing) and, to a lesser extent, ICMS. In fact, much has been said about the high taxes on fuel, particularly in international comparisons, but not much — or nothing at all — has been said about recent tax hikes. More information on the topic could help somewhat mitigate the bad impression caused by the measures adopted to bring the protests to an end, especially the subsidy granted to truck drivers.
The fact is that the nearly 100 price changes from mid-2017 to date would not have caused any

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uproar if they hadn't all been upwards — amounting to an overall price hike of more than 50%. Given these circumstances, no single rule could please everyone. The price hike needs to be passed through to customers, and the only factors taken into consideration are timing and possible mitigating factors. There's not much to be done in terms of speed. In fact, a slower pace would have allowed the company to recover part of the market share it lost, even though it would have resulted in losses for the company.
A regulatory tax would have been welcomed, since administered prices in other industries take advantage of a wide range of mechanisms to reduce price volatility to customers. It wouldn't have helped much when the company was nearly bankrupt and international prices were flat or heading south, but things definitely changed after international prices shot up.
The truck drivers' strike, or the protests — the movement cannot be easily defined — brought back memories of the 2013 demonstrations in São Paulo, which were fueled by bus fare hikes. Symptomatically, Atlas Revolt-type elements were more common than red flags in each one of

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its concentrations. However, there were some signs of a lockout, violence and calls for military intervention that created some confusion and some contrast between this movement and others organized by workers' unions. There was no interference from the Labor Courts — or even the Supreme Court, for that matter, since the authorities were not exactly sure what the demands were, which generated doubts on who had jurisdiction over the conflict.
The above paragraph can be summed up as a basic lack of control. The protest had no clear leaders and no clear guidelines, which only exacerbated how unprepared the authorities in charge of "negotiations" were and the level of improvisation involved in handling the crisis.
The government went into this

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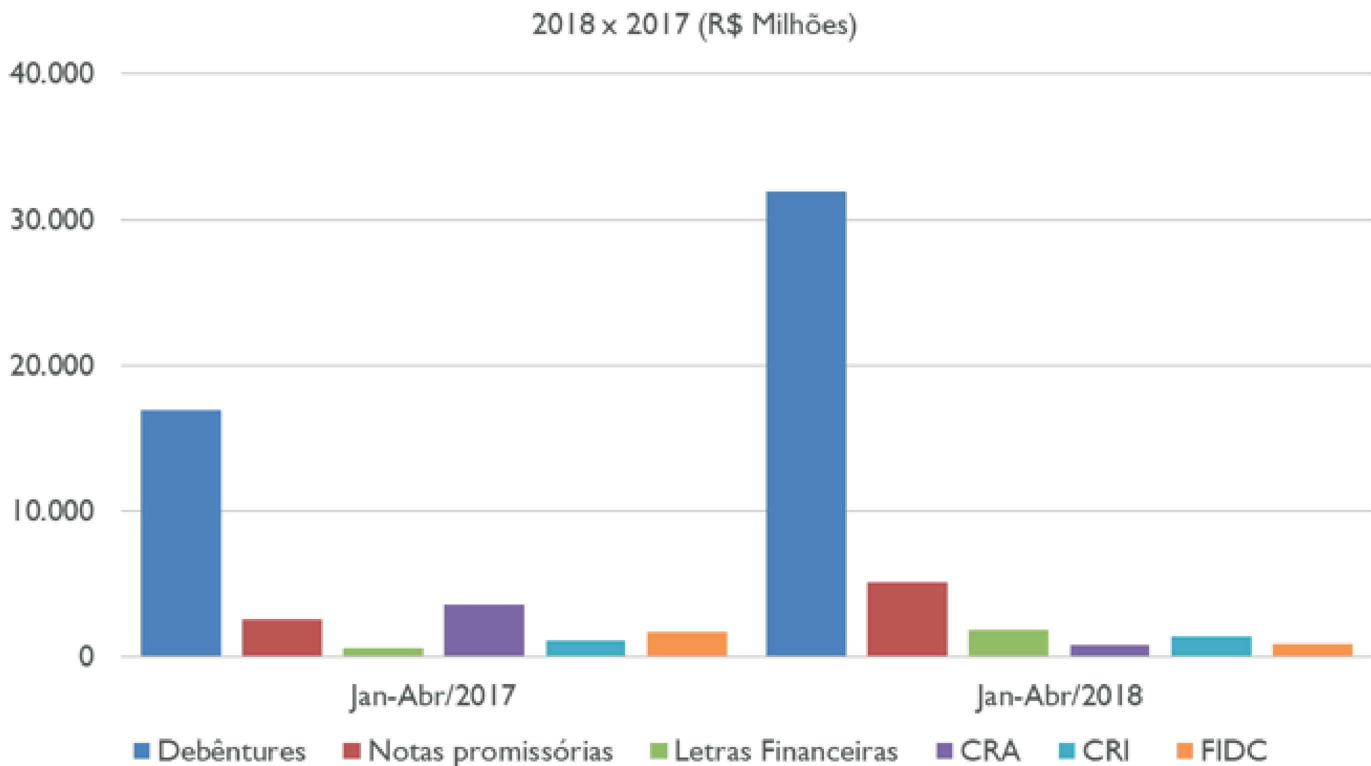
crisis in a terminal state of decline, and managed to come out even more controversial.

The crisis caused severe shortages across the country, something that had not been seen for years, while the population reacted with surprising complacency and resignation. In fact, public opinion showed some clear, albeit somewhat generic, signs of support for the movement, and staunch opposition to the government. The political damage is huge, certainly bigger than the previously accumulated capital. President Temer's utter failure is clearly evident, as his administration approaches the election with absolutely no political strength. The marriage of convenience between the MDB political party and neoliberalism, so frequently discussed in this publication, comes to an end without having fulfilled any political goals, despite the spending cap amendment and labor reform achievements. The economic staff, including the outgoing Petrobras president, Pedro Parente, fulfilled its obligations, as it performed very well within its limitations.

Pedro Parente handed in his resignation letter on June 1, in which he urged President Temer to let the company's board of directors choose the new CEO. His initiative is an important political gesture, as it puts the crisis right back onto the laps of political leaders who had been calling for him to step down. Shares fell 15% after the announcement. Who's going to replace him? In short, this new "oil shock" wasn't supposed to cause all of this turmoil, which only indicates that the problems are elsewhere — in fact, they lie higher up, all the way to the top.

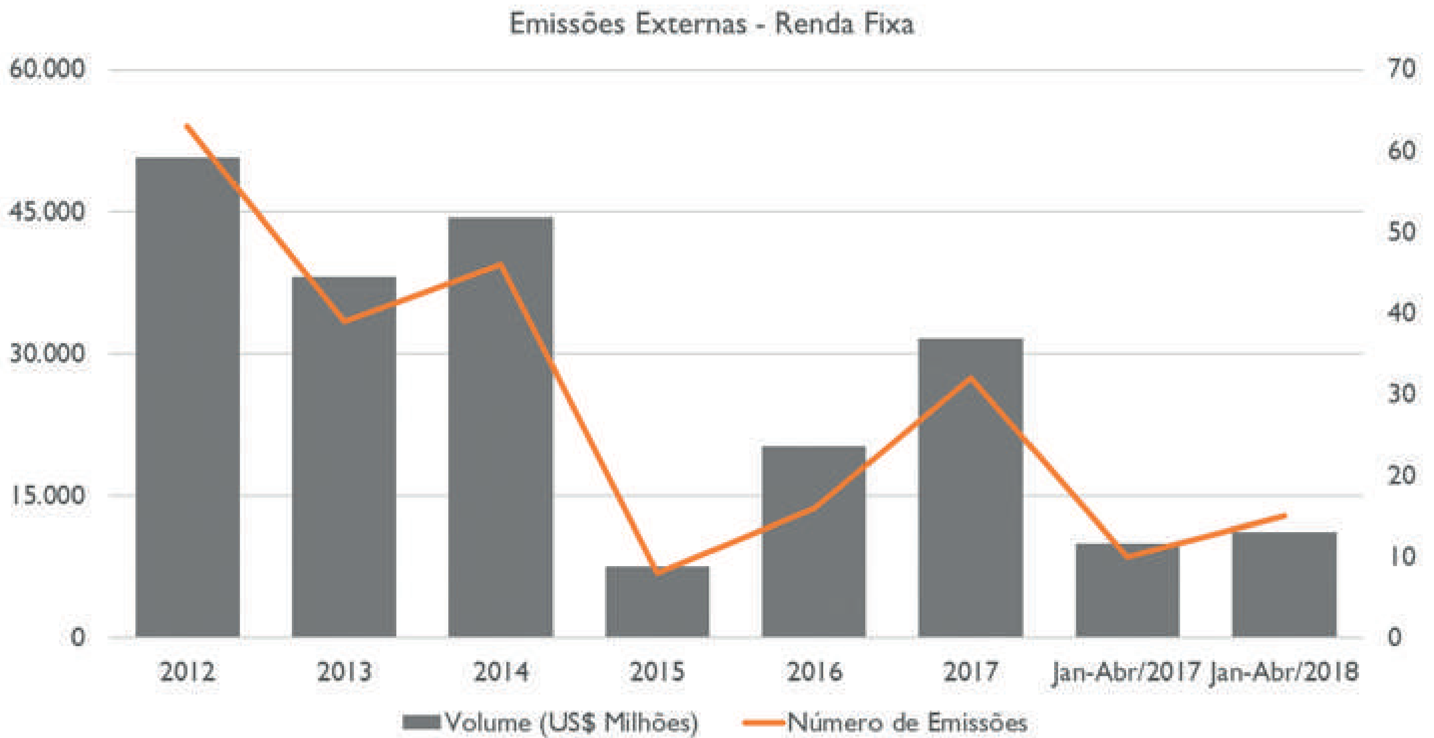
Fixed income funds (Debentures, Promissory Notes, Real Estate Receivable Credits (CRIs), Agricultural Receivable Credits (CRAs) and Investment Funds in Credit Rights (FDICS)) via domestic capital markets totaled BRL 42 billion from January through April 2018, amounting to a 58.3% increase when compared to the same period in 2017. One highlight were debentures, which accounted for BRL 31.9 billion of all funding.



The recent downturn in the macroeconomic and political environments led Brazilian companies to change their strategies with regards to issuing securities abroad. The last Brazilian company to enter foreign markets was Light, when it issued USD 600 million in 5-year bonds at a 7.375% yield in April. No issuances were announced in May. In addition to postponing their issuances, as was the case with the Coruripe Power Plant, which postponed a USD 425 million issuance because of the dollar's recent climb, some companies have announced that they will repurchase some of their foreign debt, including Petrobras, which — following in the steps of Vale and BB — announced a USD 4 billion repurchase offer.

Between January and April 2018, Brazilian companies launched a total of 15 foreign issuances, for a total of USD 11.15 billion, compared to USD 9.95 billion in the same period of 2017,

FIXED INCOME



which saw a total of 10 issuances.

Some of the companies that intend to raise funds in the domestic market over the following weeks include Multiplan (AAA Rating, BRL 300 million in a single 6-year series), Intervias (Aa2 Rating, BRL 800 million, divided into four 2-, 5-, and 7-year series) and CPFL Geração (AAA Rating, divided into two 3- and 5-year series).

In addition to the above, Volkswagen Serviços Financeiros and Carrefour Soluções Financeiras will access the market by issuing 2- and 3-year Credit Bonds.

Real estate funds are on the skids. What now?

In May 2018, a major adjustment caused significant losses to the Real Estate Fund market. The IFIX, an index that measures the profitability of a portfolio featuring the top real estate funds in the market, which had been up 5.5% for the year through mid-April of 2018, fell 4.8% in the month and is now down 1.1% for the year.

What caused this downward spiral?

Real estate funds are normally traded on the stock exchange, and behave as an equity asset. In other words, their appreciation and devaluation may depend on the offer and demand of a particular fund in the secondary market. But with the recent negative news about the foreign market, a strong appreciation of the US dollar and rising US interest rates, coupled with domestic problems such as political risks and the truck drivers' strike, investors are seeing higher risk levels for Brazil than before. As a result, the Brazilian future interest rate, which is usually measured by the NTN-B premium, rose significantly from 9.68% in April to 11.17% in May 2018. Since the real estate fund market is strongly correlated with the NTN-B, the funds also slipped. New players in the real estate fund market may be another factor behind the devaluation. From 2016 until April 2018, the number of individual tax IDs registered in B3 as real estate fund investors rose from 59,000 to 120,000, according to the B3 Real Estate Market report. Not by coincidence, the IFIX rose 24.6% during the same period. One theory is that new investors who entered the market took advantage of this downturn to sell their shares and cash in on the accumulated profits.

Although the moment demands caution in both foreign and domestic environments, real estate market fundamentals do not show any reasons for the current downturn. The vacancy rate of corporate and logistics properties in São Paulo have already shown clear signs of a slowdown since 2016, according to industry consultants. Undersupply in some regions in São Paulo could result in significant gains for property owners, who would be given more bargaining power with tenants. In regions such as JK Ave., Faria Lima, and Paulista Ave., the vacancy rate of corporate buildings is as high as 16.1%, a figure reported by Cushman & Wakefield for all types of buildings in these areas, signaling to owners that the real estate cycle is reversing, and assuring them more power in negotiations with tenants.

REAL ESTATE INVESTMENTS

What lessons can be learned from this appreciation?

First of all, real estate funds are equity investments and, while they may not be as volatile as stocks, they still carry a certain level of risk. Investors need to be aware that an investment that produces an expectation of gains above the sovereign interest rates carries some risks, including that of losses on the principal invested.

Second, the property market is cyclical and bearish and bullish movements are common. Investors need to keep an eye on this cycle if they want to take advantage of any opportunities that may emerge. The last bearish wave that took place in May 2017 caused real estate fund shares to drop, and provided some excellent opportunities for buyers. IFIX, for example, has risen 7.7% since then.

Third, real estate funds have property assets in their portfolios, and their appreciation or depreciation depend much more on their long-term outlook than on short-term bullish or bearish trends. Real estate assets tend not to lose significant value until actual events in the economy bring structural changes to the market, because as long-term investments, the market needs more time to appraise and reappraise their value.

In short, the uncertainties caused by recent events may even bring some short-term volatility, but may also bring gains to investors who can assemble a solid real estate fund portfolio.

A year after the disastrous repercussions from the audio recordings of conversations between business mogul Joesley Batista and President Michel Temer, the Brazilian financial market experienced more tension-filled days in May.

The major topic of discussion in the first half of the month was the Central Bank's decision to keep the Selic benchmark rate unchanged, at 6.5% p.a., following a Monetary Policy meeting on May 16. While it wasn't exactly unanimous, most market agents believed that the rates would drop 0.25%, causing a major increase in the interest rate spread, a negative impact on the stock market and little effect on the exchange rate, as the currency had already depreciated in previous months. What seems rational is not always obvious — and if the Central Bank can stop the interest rate cutting cycle moved by external factors, it should be able to do so for the same reasons. The truth is that inflation data remain below expectations, as activity numbers are continuously being revised downwards. In its statement, the Central Bank did not shut the door on new cuts being announced at its upcoming meetings, but left the current rate as its base outlook.

However, the month was still far from being over, and the last ten days were marked by the truck drivers' strike, which lasted longer than originally expected, causing severe impacts on our economy. After failed attempts at reaching an agreement, the government relented to practically all of the movement's demands in order to bring the generalized chaos to an end. The implemented measures hit Petrobras particularly hard, as domestic and foreign investors saw that it is still subject to government influence, despite some major improvements to the company's governance practices. Its shares (PETR4) fell 17.37% in the month and dragged the Brazilian stock market down with it, as concerns spread beyond Petrobras' performance and led to greater risk aversion by investors who became fearful of the current environment and the still uncertain outlook for the presidential race. Ibovespa fell 10.87% in May, offsetting the market's gains in 2018.

The local scenario was so troubling in May that it ended up partially overshadowing international news — and there was plenty of that to go around as well. In the United States, treasury yields continued to climb for most of the month.

The market is fearful that U.S. activity may be more robust than its potential growth, and has been carefully monitoring every new inflation, activity and job report. Upward surprises with indicators could speed up the interest rate hikes expected by the Fed, which has already caused some impact on global markets, especially as the dollar continues to strengthen against emerging currencies, and emerging markets also see their stock markets dropping and funds flowing out of their economies and into fixed income securities in the United States. In Europe, activity remains sluggish, with data

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slightly weaker than expected, which reinforces the idea that the expansionary monetary policy cycle is far from over. This combination of factors paints the challenging scenario faced by market agents during the month of May.

DIRECT ASSET MANAGEMENT

It was another very difficult month for multimarkets, with fixed income positions suffering some major impacts after the Monetary Policy meeting (read more below in Portfolio Allocation). For the first time since inception, Apollo FIC FIM had a negative month — even though it remained in line with the rest of the industry. At times like this, it is very important to focus on structural positions whose value is aligned with our macroeconomic outlook, even if short-term volatility may prevent us from cashing in immediately. As can be seen in and heard from multimarkets, a consistent body of results over different and wider timeframes is often built during times like these.
Our biggest struggles came from FRA 2020 and NTN-B 2026, as well as real estate funds, which were hit by a major sell-off. We had already cut down on stock exchange and currency positions, to the point that they didn't have much of an effect on the results, with tactical operations in both asset classes being able to mitigate the month's results. The positive highlights were quantitative models and their non-correlation with the fund portfolio. With only 5% of net equity (PL), quantitative cash generated 13bps.
Overall, the Rio Bravo Apollo FIC FIM was – 2.12% for the month, in line with IHFA (-1.39%). Now 17 months after inception, the fund has seen 16 positive months, 14 of which were above the CDI rate (compared to 7 months above and 10 months below the CDI for the "Brazil kit").
We focus our positions on the slope of the curve, which offers very high premiums for our current macroeconomic situation. We increased FRA 2020 to 2 PLs, and transferred a small share to FRA 2021.
We also kept 0.3 PL of NTN-B 2026, which we expect to switch for the risk equivalent of FRA 2021, currently with a premium of 600 bps for the basic interest rate. Finally, we had reduced our real estate fund allocations by 15% before the sell-off, which we will keep for its carryover and short-term capital gain potential.

PORTFOLIO ALLOCATION

Private credit fixed-income funds matched expectations for their high-grade categories (lower credit risk securities). These funds have seen their returns diminish gradually, and should continue to reflect the tight spread profile of credit offers that reach the market. Nonetheless, we still find these

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funds to be an attractive option, depending on their risk-return ratio, and the resilience profile that can guarantee returns above the CDI rate for portfolios in more volatile environments.

May was a make-or-break month for multimarket funds, with several surprises when compared to the base outlook, such as the Monetary Policy Committee decision and the truck drivers' strike.

Coupled with the strengthening of the U.S. dollar, these factors were largely responsible for the funds' poor performance. The vast majority of macro multimarket funds suffered with this event, especially in the nominal and real Brazilian interest rate positions.

For the month, the IMA-B — which measures the performance of a basket of NTN-Bs ("Treasury IPCA+") — fell 3.16%, while the IRF-M — which measures the performance of a basket of LTNs ("Prefixed Treasury") — was down 1.85%.

The IHFA, which measures the performance of a basket of multimarket funds, had a negative return of -1.39% in May. Due to stress in the interest rate, currency and stock markets, most funds in this category closed out May with negative results. Only a few managed to end the month with positive figures, and even fewer managed to generate returns above the benchmark (CDI).

In any case, it should be noted that, when investing in these funds, the investment horizon should not take short periods such as one month into account. A longer-term analysis is more advisable — ideally, it should be longer than 12 months. Making decisions based on poor short-term results can lead to losses and prevent the chance of medium-term recovery. We will continue to see volatility in these funds over the coming months, as we have already noted in our letters, as a result of the upcoming presidential election. We continue to recommend a selective and diversified allocation of resources in this class, and investors should always keep short-term risks in mind.

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 shares that, despite turning in negative results, managed to outperform Ibovespa.

We do not currently have a significant share of our resources allocated in stock market funds and, even though the downturn could provide some great opportunities, the outlook for the next few months remains very uncertain.

The market for real estate funds ("FIIs") also had a rough month, suffering hard losses that ended up offsetting the positive results achieved earlier in the year. The IFIX, which measures returns from a basket of FIIs, came in at -5,27% in May, for a 2018 year-to-date result of -0,55%. However, our monitoring and

analysis do not indicate any reasons for the significant decline in the month, which apparently signals

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a risk off movement that is not directly related to these specific assets.

We are approaching another semiannual reassessment, and will dedicate much of our next letter to discuss our allocations, changes, and outlooks for the rest of 2018

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 FIC	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 IE	Rio Bravo Pandas FIC FIM
May 18	0.52	0.44	-9.56	-212	-121	-1.12	4.49	-9.32	-2.41	-595	583	188
April 18	0.52	0.45	-5.30	0.02	030	0.16	6.54	0.15	0.08	-051	392	-099
March 18	0.54	0.47	0.34	1.79	125	0.56	0.34	0.32	2.33	-036	262	213
February 18	0.50	0.41	-3.65	1.08	054	0.42	-0.66	-1.67	1.26	025	-316	240
January 18	0.62	0.54	7.98	0.69	117	1.87	-2.91	7.06	0.97	384	070	207
December 17	0.54	0.48	4.90	1.00	106	1.00	0.91	4.59	1,42	162	102	336
November 17	0.58	0.50	-3.13	0.58	030	0.31	-0.26	-3.02	0.49	-082	099	121
October 17	0.64	0.59	0.55	0.67	123	0.29	3.56	-0.55	0.26	044	525	196
September 17	0.64	0.58	3.46	1.65	1,34	1.46	0.72	3.64	1.63	204	298	172
August 17	0.80	0.75	5.54	0.88	1.17	1.10	1.64	5.20	1.19	276	075	029
July 17	0.84	0.75	3.85	0.90	0.88	1.47	-4.54	3.79	2.25	351	-250	105
June 17	0.99	0.78	0.73	1.06	0.97	0.79	1.54	0.92	018	-064	117	020
May 17	1.00	0.88	-2.45	0.31	0.44	-0.02	2.18	-1.66	014	-007	760	161
Year	2.73	2.34	-10.59	14.25	2.05	1.89	7.74	-4.09	219	-294	1007	768
12 months	7.99	6.94	4.35	-	9.37	8.63	11.43	10.51	997	591	2118	1862
24 months	23.06	20.57	8.19	-	27.16	22.57	5.45	33.96	2482	2005	2584	3057
36 months	40.32	36.56	8.43	-	40.72	38.44	19.54	35.66	3983	2995	-	-
48 months	56.70	51.54	1.18	-	-	52.84	58.90	29.51	5635	3447	-	-
From the beginning	174.23	172.06	458.60	14.25	49.77	179.69	62.36	32.83	10756	3455	1746	3747
Current NW (in BRL thousands)	353.585	8.432	8.761	67.379	76.317	11.466	4.175	6.362	20881	12936	39743	4072
Inception date	14/08/08	28/12/07	8/09/04	4/01/17	9/10/14	3/11/08	11/12/13	16/04/12	8/04/11	12/03/13	29/09/15	17/08/15
Administration fee (p.a.)	0.45%	0.35%	2.00%	1.50%	0.04%	0.60%	1.75%		085%	110%	008%	090%
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

	CDI	Ibovespa	SMLL	Euro	U.S. Dollar	FTSE BRL (ex-UK)	IMA - B	IFIX
May 18	052	-1087	-1131	2.70	6.21	0.98	-3.16	-5.27
April 18	052	088	237	4.08	6.05	6.83	-0.14	-0.86
March 18	053	001	007	2.66	1.81	-0.31	0.94	2.00
February 18	047	052	-037	0.13	1.88	-3.47	0.55	1.15
January 18	061	1114	434	-0.1	-3,78	2.30	3.43	2.64
December 17	054	616	703	1.85	1.36	1.56	0.80	0.60
November 17	057	-315	-243	2.04	-0.10	0.02	-0.76	-0.59
October 17	065	0.02	-148	1.99	3.44	4.12	-0.38	0.23
September 17	064	4.88	368	-0.37	0.43	3.54	1.81	6.58
August 17	080	7.46	855	1.33	0.76	0.87	1.34	0.86
July 17	080	4.80	814	-2.11	-5.53	-2.23	.00	-0.38
June 17	081	0.30	039	4.21	2.52	0.88	0.16	0.85
May 17	093	-4.12	-108	4.79	1.58	5.82	-1.19	1.03
Year	267	23.90	-555	9.75	12.41	6.19	1.48	-0.55
12 months	768	22.39	1873	19.82	15.40	15.69	8.72	7.65
24 months	2209	5648	7223	8.29	3.11	-	25.50	38.16
36 months	3901	4548	5295	24.39	17.15	-	43.20	56.19
48 months	5498	4873	27.08	40.43	63.57	-	63.90	61.84

[1] Maximum Administration Fee, including the management fee of the invested funds: 0.50% p.a.
[2] Maximum administration fee, including administration fees of invested funds: 1.10% p.a.

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