BlueLine
ASSET MANAGEMENT

MONTHLY LETTER I **July** 2020

Results of the month of July. The Blue Alpha fund posted a positive performance of 84bps in July, with 84bps coming mainly from equities, 19bps from rates and virtually neutral FX results. The difference comes from cash and expenses. In equities, our global portfolio with geographical and sectorial diversification allowed us to capitalize on a favorable scenario across many fronts, maintaining a controlled risk. On the rates front, last month's gains were more concentrated in Brazil's positions. With more tactical positions in the FX portfolio, the high global volatility led to losses and gains that practically cancelled out each other in the month.

Overview. Following the haphazard global economic downturn and the first steps of recovery thanks to the rollout of economic stimuli, we have now entered into a stage of stabler recovery, which relies essentially on each country's ability to keep Covid-19 on a leash, as well as the resources to maintain the stimuli and promote political articulation. Based on these parameters, it is no wonder we're seeing a "V-shaped" recovery in China and better prospects in Europe compared to the U.S. – which has been struggling to maintain fiscal stimuli and put a lid on new Covid-19 cases. In Brazil, after a wave of good news regarding better growth results, low inflation and less political backlash, the second half of the year comes with major decisions on the fiscal side. Political pressures to increase social and infrastructure spending make it much harder to stay under the spending cap, and the government's approach to handle these opposing forces could spell out tension in the market.

Market Overview Global markets maintained a steady recovery trend in July. One of the most interesting events this month is the unwaveringly dropping real interest rate in the U.S. The 5-year real interest rate kicked off the year near zero and now hovers around -1.27%. Much of this decrease in U.S. real interest stems from the continuous drop in the nominal interest rate, due to uncertainties surrounding the impacts of Covid-19 in the global economy. More recently, the drop in real interest rate can be attributed to the higher breakeven inflation (or implied inflation). The 5-year breakeven inflation in the U.S. started the year around 1.6% and plummeted to near zero between March and April, during the worst point of the health crisis. Since then, it has started to climb back up, reflecting a general improvement in global sentiment after so many rounds of monetary and fiscal stimuli. This factor – dropping real interest due to higher breakeven inflation – has driven asset prices such as international exchanges and gold, and has also explained the depreciation of the U.S. dollar.

The question that naturally came to light was why did this factor not appreciate emerging currencies compared to the U.S. dollar more recently? The answer is two-fold. The first part is the lack of the carry component so often seen recently in this asset class among these emerging economies. The second is the complete lack of confidence of global investors towards cyclical assets, as is the case of cyclical stocks and emerging currencies. The lower real interest rate explained by the upsurge in breakeven inflation can also be explained by other factors other than just stimuli, such as the exceptional results recorded by companies in the developed world.

Positioning. In rates, we maintained positions in the intermediary stretch of the curve in Brazil and in the front of Mexico. In exchanges, we have a diversified global portfolio both in geographical and sectorial terms. The main highlights in the U.S. market include the technology, healthcare, commodities, small caps and value sectors. In Europe, we hold positions in commodities and healthcare. In addition, we also have a position in a stock exchange in emerging Asia. In Brazil, the highlights are financial services, logistics, utilities, and e-commerce, but we also hold positions in banks and commodities. FX positions seek to capitalize on the weaker U.S. dollar compared to other currencies, especially those from developed countries and Asian emerging nations.

LatAm

In Brazil, the general improvement overseas also finds Brazil in a better local individual condition, mostly explained by relieved political tensions in the nation's capital, with an apparent truce between the three branches of power, at least for now. The best indicator of this current scenario is how the debate surrounding the potential impeachment of President Bolsonaro seems to have dwindled down, steering discussions back to the country's reforms. The radical shift in the president's posture, leaving his regular combative stance and adopting a calmer and more pragmatic attitude, explains most of this improvement in the tone of local assets. Brazil's stock market outperformed many other foreign exchanges, and interest rates continue to drop, especially after the release of the IPCA 15 in June, although the BRL was the asset with lowest capitalization during this period of global and local upturn.

In Mexico, more vulnerabilities of the country's economy are exposed as the global health crisis unfolds. The lack of fiscal support coming from the government has pushed Mexico's economy into one of the worst recessions among emerging and developed economies in 2020. Economists already forecast a double-digit downturn in the current year. To make matters worse, the country's inflation remains resilient, creating a scenario of stagflation. This places all of the economy's support on the "back" of Banxico. Therefore, it is our opinion that the terminal rate in Mexico should hover around 3% in the one-year horizon.

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