FCL*Capital*

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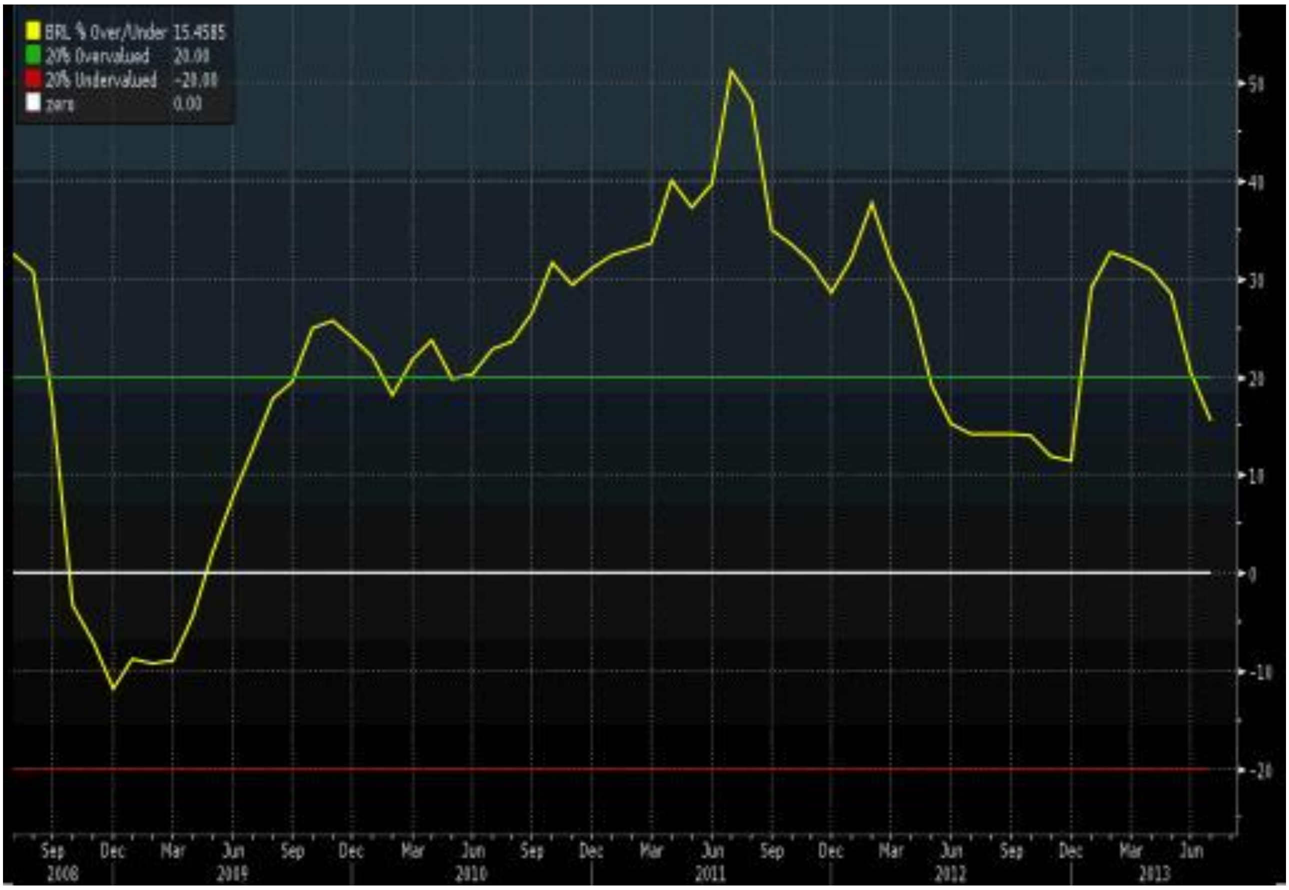
After ten years, the house of cards starts crumbling

One of the most basic rules of political analysts around the world is to never pay attention to what politicians say. Instead, we should focus on what politicians do.

Having a former factory worker as their first president, it was quite obvious that the leftist worker's party would say that they would improve the "incentives for production" and take them away from the financial sector. Visiting Embraer factories were necessary for candidates in the now long gone Brazilian presidential election of 2002.

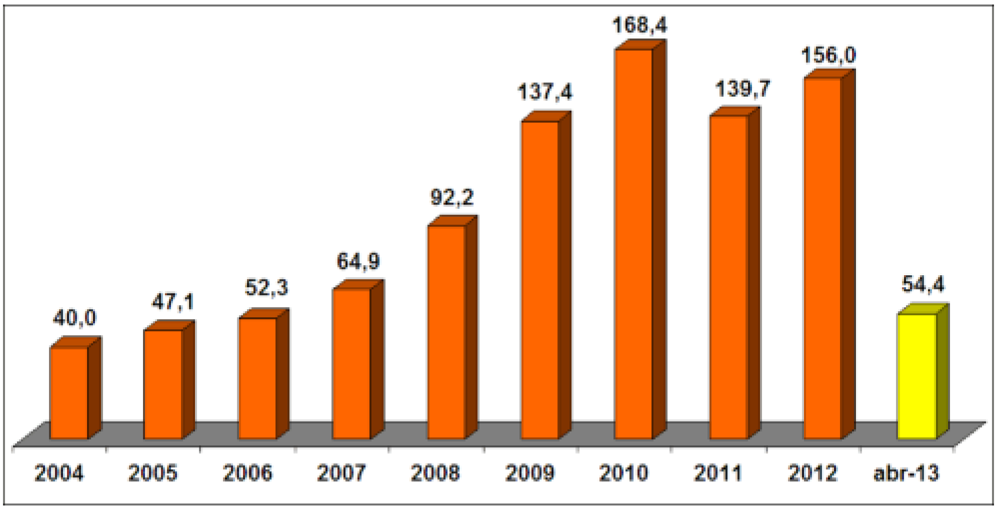
What we have seen, on the other hand, is that since 2005, when the Brazilian economic direction clearly had an inflection point, more and more value has been taken away from industrial and productive sectors and canalized to the service/consumption sector. This has been done, sometimes consciously, sometimes inadvertently, sometimes by ideology, sometimes answering to organized pressure, through government policies in the last few years, some of them listed below:

1) A clearly overpriced exchange rate that diverted incentives from production to consumption.



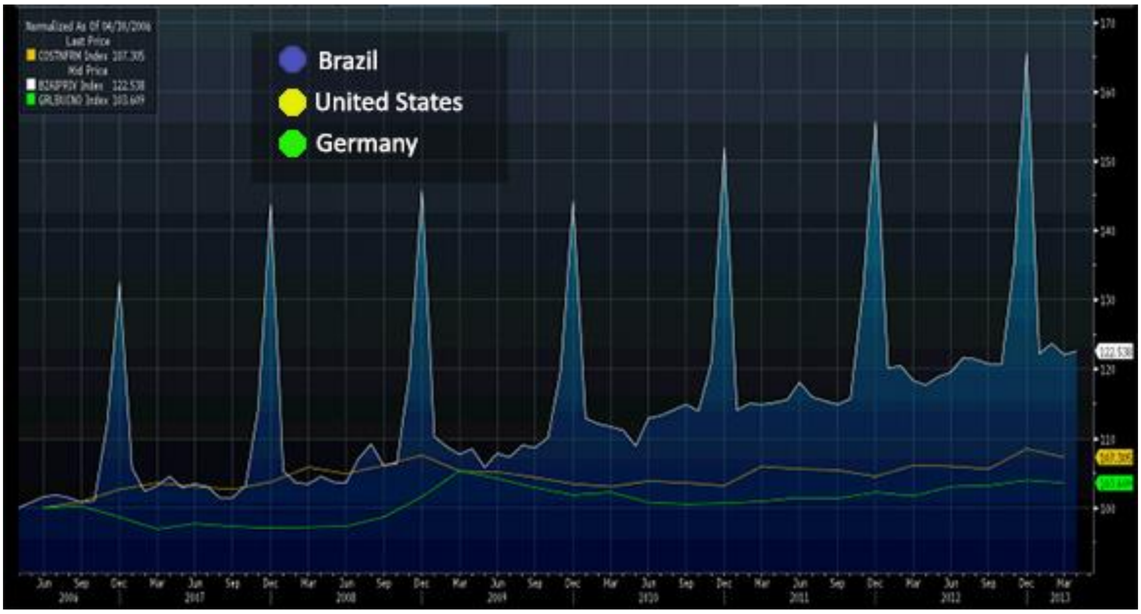
Purchase Power Parity of Real vs Dollar from 1st of July 2008 until the 28th of June 2013. Source: Bloomberg.

2) Credit incentives.



BNDES's Desinbursement. Source: BNDES.

3) Skyrocketing unit labor costs.



Unit labor costs in the past 5 years. OBS: In Brazil, the costs tipicaly jump in december. Source: Bloomberg

The quite obvious result is that investments related to domestic consumption were one of the few bright spots in the Bovespa. A rising unit labor cost combined to an over appreciated exchange rate would guarantee that everyone focused on the Brazilian domestic consumption would do well.

Consumer Index (ICON) vs Ibovespa Index in the last 3 years. Source: Financial Times.

As in any bull markets, an industry of theses and explanations on why domestic consumption should rise quickly followed. A myth of a "new bovespa" against the old one, plagued by commodities' exposition and government intervention quickly followed.

We firmly believe that this house of cards is finally crumbling: For starters, we believe in the philosophical affirmation that everything that cannot last forever eventually won't. There are already very clear signs saying that this trend is reaching its inevitable end and the "old Bovespa", with a range of industries that Brazil has a comparative advantage, like agribusiness, exporters, and yes, some commodities producers, will be where value lies in the mid-term future. So we are long "old Bovespa" versus the new one. There are a few already very clear sings supporting our thesis:

1) The exchange rate in finally depreciating. There's much, much more to come. We are not macro analysis, but we believe an exchange rate closer to R$ 2.60 per dollar would make sense. Brazil's balance of payments is deteriorating really fast and this exchange rate would still be below Brazil's PPP;

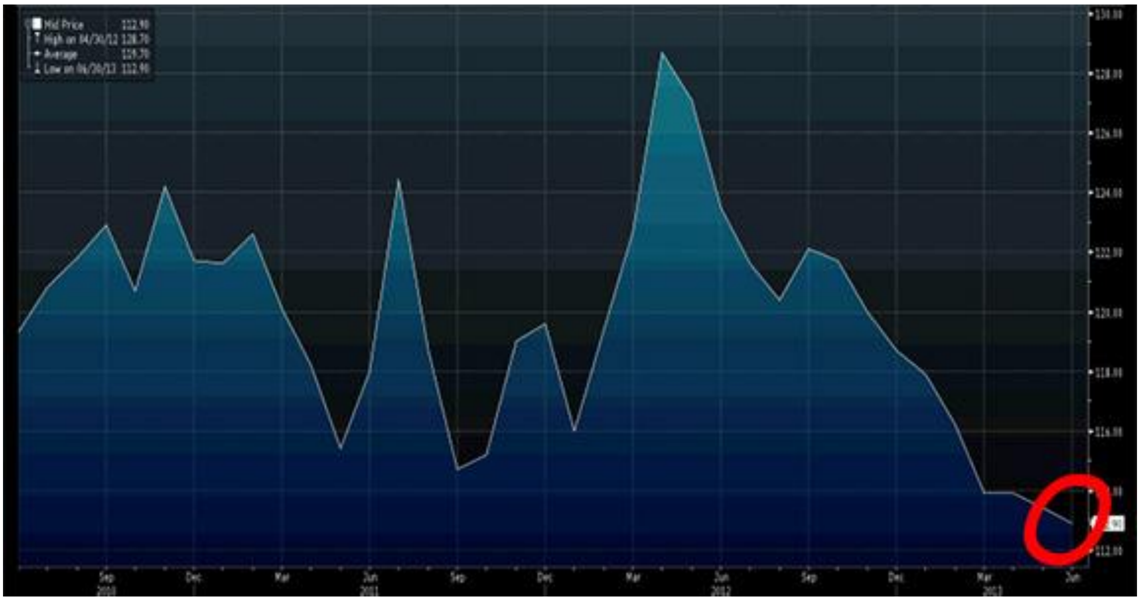
Deteriorating balance of payments are reaching a deficit of 3.2% of GDP

Purchase Power Parity of Real vs Mexican Peso from 1st of July 2008 until the 31th of May 2013. Source: Bloomberg.

2) Credit policies clearly reached a saturation point, especially with a tighter fiscal situation;

3) The labor market is turning, the real wage gains are slowing and some uptick in unemployment levels may follow. No economy works in full employment permanently and Brazil is no exception;

4) Last but not least, consumer confidence is starting to erode.



Consumer confidence index in the last 5 years. Source: Bloomberg.

So our basic thesis is that the exchange rate will depreciate further and value will flow from consumption back to production. Gladly, we were able to position our portfolio for the change of times we were envisioning:

- 65% of our portfolio is made of companies that would significantly benefit from a weaker Brazilian exchange rate (basically Braskem, Gerdau & Minerva);

- We have no exposition to overpriced retailers or companies that were “protected” buy its sole exposition to the domestic economy;

  We are short on overpriced domestic companies and/or companies that went public at the top of the Brazilian consumption bubble.

The Brazilian stock index was one of the worst performing indexes worldwide over the last few years. But contrary to, say, Greece, Brazil’s economy has not experienced a recession. So why has the index performed so poorly?

The explanation, in our opinion, is quite simple. The economy was not particularly bad and the companies’ revenues kept increasing, but the margins nosedived. And the reason is quite simple: a combination of an out of place exchange rate and skyrocketing unit labor costs. These factors combined took away the competitiveness from companies even in sectors where Brazil has had an historical comparative advantage[1].

The good news is that since the government model has clearly been proven wrong, the market can correct it alone. Both the exchange rate and the unit labor costs are reversing their trends. So, we think the “old Bovespa” will somehow reemerge.

Of course, an investor in Brazil has to be selective. We will always avoid companies that have strong government influence in Brazil. We just don’t want the government to be our partner. Ever. We believe in shareholders alignment and in companies that answer to capitalist incentives.

That being said, a weaker labor market and exchange rate should be enough for the margins of many Brazilian companies to recover rapidly, even in a country where the finance minister is put to ridicule on a daily basis by his own affirmations and where inflation fighting has not been much of a priority.

We are especially worried about two sectors of Bovespa:

1) Companies focused on Brazilian discretionary consumption. We think the Brazilian consumers may tighten their belts in the next few years, feeling a different reality than the one they believed in and that the government was claiming to be truthful;

2) The so called “clean stories”. Everything has a price. The price being paid by everything that yields anything has gone through the roof for too long. Everything that has to stop eventually will. So our portfolio is less concentrated in dividend paying companies than it has been historically and we think this has only improved our margin of safety.

Company	Ticker	Price to Book Value
Gerdau Metalúrgica	GOAU4	0.65
Braskem	BRKM5	1.56
Lojas Renner	LREN3	5.85
Odontoprev	ODPV3	6.46

[1] We are not saying that we agree with government intervention to adjust exchange rates. We do not believe in government intervention. We believe the opposite, that government intervention, especially through high expenditure levels is what contributed to the lousy exchange rate level the Brazilian currency is currently experimenting.

Performance

FIA FCL Equities' performance was of (5.4855)% in the first semester, comparing favorably to (22.1404)% of the Ibovespa index, its benchmark.

Obviously, our relatively favorable performance may seem a small consolation given the huge decline in the index this semester, but then comes the beauty of stock investment: investors that can afford the volatility in the short term usually get returns substantially in excess if compared to fixed income in the long run.

As we said in our letter about the stock market cycles, periods of euphoria lay the seeds for its own subsequent periods of below-average performance and bad times bring on themselves the ingredients for subsequent boons.

In this sense, our recommendation for our investors at this time is to not redeem their shares at current depreciated prices, except in case of extreme necessity, since they have right now, in our opinion, one of the most significant potential for upside in our history.

From the April 3rd, 2007 until June 28th, 2013 our shares went from the value of 1 to 2.7805 per share, while the Ibovespa went from 46,288 to 47.457 points. Using simple math to consider Ibovespa's starting date as April 3rd, 2007 with a "share value" of 1, we find that on June 30th, 2013 it would be worth only 1.0252.

To put it another way, nearly 100% of our appreciation in this period of more than six years was pure alpha, without any "help from the index". We are confident that we will go through periods that are more favorable to equity investment in Brazil, and we intend to reap the benefits of these future periods.