

# FCL*Capital*

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## In Trump we don't trust

The news cycle, and consequently, the global investment community's attention this past month was dominated by the election of Donald Trump.

Many analysis have already been written about the wider context of a Trump win ( we will not hide our personal views: this house is sickened by actions such as targeting a specific religion, selectively denying entry even to green card holders and building a useless "wall" with Mexico.

Also, a lot of research pieces have been written about the potential positives and negatives of a Trump win to the stock market– in particular during the trading days following the election, when we saw a surge in financial and healthcare stocks and a rally for the dollar. Investors are betting that Trump will cut taxes and regulations and use a fiscal stimulus.

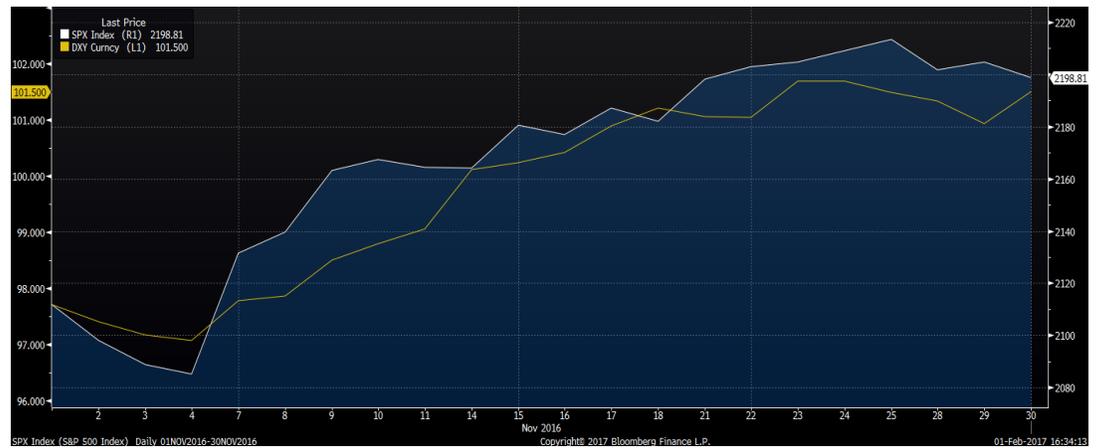


Chart 1: S&P500 and Dollar Indexes post Trump win

This will not be the theme of this letter. Instead, this letter will be focused on an analogy: counterintuitive as it may seem , especially coming from an emerging market, we do think that the cycle in power of the PT workers party in Brazil, that lasted from 2003 to 2016, has insightful

lessons to what American investors and businessmen can expect for the next four, and maybe eight years.

It will be quite a ride, so here is the general blueprint of what to expect from any populist, unpredictable and energetic new administration.

Usually, we think, the cycle of power of these kinds of administrations in democratic nations, like Brazil and the US, has four distinct phases:

## **Phase 1- The Euphoria**

After a few failed attempts, the workers party rose to power in Brazil in January 2003 with the first election of Lula. There was a lot of fear among business folk since Lula always pledged to repudiate international commitments, raise taxes on the rich and “give to the poor”. A decade before his election a prominent businessman even declared that thousands of Brazilian businessman were ready to leave the country, should Lula ever win a presidential election.

To the positive surprise of many, Lula started his government being mostly a moderate. He did try a few radical steps, particularly against freedom of the press, but the Brazilian institutions were robust enough to defeat him, just like America’s institutions will surely bring many disappointments to Trump’s cabinet.

After a while, the veil of uncertainty was gone. Lula did not repudiate Brazil’s international debt after all. The Brazilian Real and stockmarket soared.



**Chart 2: Bovespa and Brazilian Real vs Dollar: Base 100. Lula years 2003-2010**

Lula was also able, through what we now know were questionable methods, to have a majority in congress. Important reforms were passed in the first couple of years.

Likewise, for the first time in a decade, an American president will have control of both congress houses. There are indeed many useful things Trump could do. Any attempt to reform America's tax system is positive: from its horrible global system of taxation to the high rates filled with exemptions that make the code look like a Swiss cheese and be endlessly gamed by American multinationals, hoarding their cash abroad, surely a good reform would be a major positive for the American economy and its stock market.

And for all his horrible instincts, the old republican insight that the endless web of regulations chokes entrepreneurs, especially smaller ones, has our sympathy. Wiping out excessive regulations would be a huge positive surprise. Anything Trump can do to unleash animal spirits in America will have ours and more importantly, the stock market's support.

But there's more and it is here that things take a turn for the worse: as any populist and mediatic administration, Lula and the PT also did a lot of things not only to do good, but to look good, especially to their electoral

bases and especially with the short term in mind. Things they knew were irresponsible but that on the short term brought them popularity, like big raises in the minimum wage, fiscal expansionism that made the Brazilian currency appreciate, fiscal stimulus to a few chosen industries ( industrials in particular at first were in love with the PT party) and so on.

We also suspect president Trump will do many of those things. He will probably lead a fiscal expansion that will make the dollar appreciate. He will choose a few certain sectors and industries, particularly in his Midwestern voter base, or directed at bosses that were friendly to him. The bottom line is, he will do unpredictable things to raise his popularity in the short term, things that will have to be dealt with once the long term arrives as it eventually and catastrophically did in Brazil.

Mostly, he will be able to get things done. He will offer incentives or bully companies so their workers will keep their jobs. He may deliver a fiscal stimulus. The import barriers if implemented will surely produce some winners. So after some doubts, his voters may be happy with him. Finally a president who can keep his promises! He did it!

So if we had to guess, our best guess is that in the first year of Trump's administration, the stock market will go up. We wouldn't even be surprised if there is some kind of euphoria. The good times never sound like they will ever end.

## **Phase 2 - A game of "how to game the system"**

After a year or so into an administration, a certain previsibility and "normality" starts to appear. Preferences that were hidden start to be shown.

There are many ironies when we compare the PT and Trump administrations. The first is that, while professing a special love for the "rustbelt", for factory workers, industrials, and "makers" instead of "financiers", governments that are too preoccupied with popularity tend to build a set of policies that favor consume in detriment of production.

In Brazil’s case the package was heavy: subsidized credit, an overvalued exchange rate due to an expansionary fiscal policy, “bullying” of certain utility providers not to raise prices, sometimes singling out them by name just like Trump is starting to do in the US, and so on.

The result was simple: in the Brazilian stock market the consumer sector boomed while industrials suffered



**Chart 3: Bovespa consumer companies ETF vs industrials ETF**

Also, any voluntarious administration starts to have its “yes man” and a group of insiders starts to form. They will reap many benefits: they will be the president’s men - in the case of Brazil, they were lavished with subsidies and in the more transparent and less statist USA we suspect they will at least be lavished with praise.

The fact is, that just like a few brave hearted Brazilian entrepreneurs decided to take a chance and befriend the PT since day 1 and were dully rewarded for that, we would expect heavy rewards to the businessmen now in the media declaring that trump should be “taken seriously but not literally”

And even more interesting, even the early Trump cabinet appointments with their internal tension are starting to resemble the Brazilian experience. Rex Tillerson, a former Exxon CEO will bring some credibility just like Jose Alencar, a textile magnate did on Lula's first term.

At the same time, the most intransigent and radical face of the government, that is represented by Stephen Bannon in the US , who many people are already crediting as being the real power broker behind the president, is almost an exact replica of the role once occupied by Jose Dirceu in the first Lula government.

The fact is, during phase 2 things start to diverge. The stock market as a whole will move sideways, but now there will be a huge internal transfer of value and a division between winners and losers, once people realize how the system works and how to game it. Smart investors will start to avoid some sectors and companies in favour of others.

### **Fase 3: The cracks appear**

After a few years, in Brazil's case with the third consecutive PT administration and the election of Dilma Rousseff as president, the cracks started to appear. But note how long the long term took to show up: Lula walked out as president enjoying sky high popularity.

For quite a few years, the administration short term policies were just about keeping most people happy. And here the Brazilian and American experiences start to diverge: due to its unrivalled civil society, it is likely that Trump will face heavy criticisms and scrutiny from day one. In Brazil's case, the state's heavy hand forced the vast majority of businessmen to keep their mouths shut until the PT and the country were very near collapse.

But first things first.

In the third phase, stock markets start to nosedive. Articles about the country's disappointing productivity rate are frequently written. Many will blame the administration and its set of policies that keep the currency and the deficit too high, previsibility too low and a perpetual sense of a heavy hand that bullies and picks winners and losers, not letting the market decide by itself.

The divergence of the previous phase ceases to exist: the economy's next turn for the worse hurts everyone because business confidence starts to decline. Businessmen no longer feel confident enough to announce expansions and investments. They know that depending on the mood of the times they might be hurt by a change in regulations and some bullying.

Sooner or later business confidence starts to spread to consumer confidence. The the next piece of the domino falls. Consumer confidence starts to hurt retail sales and eventually unemployment levels start to be a worry.

Businessmen start to make courageous statements denouncing the administration. The stock market plunges.

#### **Phase 4: Meltdown**

Economic meltdowns are like plane crashes: they require a combination of bad ingredients combined with bad luck, they are slow in the making but once they arrive, they are fast and furious

Most Brazilians don't even realize but the country was close to a complete meltdown in early 2016. An economic depression that made its GDP fall a combined 10% from peak to trough, currency devaluation, rise in unemployment and a decline in faith in the institutions that even made a significant part of the population ask for a military intervention. Many

businessmen were already moving their families abroad. At its peak, the country was on the verge of social convulsion.

Then, fortunately, an unexpected turn of events resulted in impeachment of the president, change in the administration, and saner economic policies that rescued the country from the verge of the abysses and brought a turn for the better for the country.

We are not suggesting the USA will experience anything as dramatic.

For one thing, just as Brazil is on a different level of credibility, seriousness and institutions when compared to, say, Venezuela, the US is also decades ahead of Brazil. Second, for all his personal flaws, Trump is a successful businessman and while he is a statist and believes in his individual power to bully and decide as opposed to trusting the market, he also believes in low taxes and light touch regulations. The PT, on the other hand, was formed by former Marxist and guerrilla leaders. As any analogy, this one shouldn't be stretched too far.

That being said, we expect tough years ahead for the US stockmarket and possibly even its currency. We do not share the enthusiasm many investors are showing to the possible Trump stimulus package (unnecessary and wasteful in our opinion) and think in the end the administration policies will hurt American assets.

Since our new Opportunities fund invests heavily in American companies (still by far the best managed and most exciting in the world as a group) the above discussion is not merely academic.

Sure, just like any global fund, Opportunities will keep investing in American companies. But on the margin it is possible our current skepticism with Trump will tilt our allocation a bit more towards Asia and Europe when compared to America. To use the jargon, we would be "underweight" America for now.

America will go through a lot in the next four years. Brazilians have already seen this film of a voluncharious president that says the country was “refounded” and now everything will be better and different. The overconfidence quickly turns into arrogance, particularly while the president’s popularity is high and each step leads to another one, from euphoria, to system gaming, to cracks appearing, to economic crisis.

Ironically enough, this film has just ended in Brazil. We just hope that we are being too pessimistic and that it does not have a sequel in the world’s most important economy.

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