Planner Redwood Asset Management

MONTHLY COMMENTARY

OCTOBER 2014

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Introduction

That’s it. The presidential race is finished and Ms. Dilma Rousseff was re-elected to lead the country for another four years. Out of the population of around 200 million people, 140 million of them voters, 113 million actually voted, giving the victory to President Dilma - a display of democracy. This was not a very impressive victory in percentage terms, but the polarization during the campaign, "poor x rich", "north x south", and especially "us against them" was certainly disconcerting.

However, in her first speech after being re-elected, the president called for dialogue with everybody. A simple, beautiful, well-intentioned and opportunistic act. The fact is that the population, regardless of rights and wrongs of each side, broadly endorsed the current government and its " modus operandi" since the election of President Lula. Paradoxical as the result of the vote may be, considering the popular manifestations of mid last year, the Brazilian population has decided that the current government is better able to promote change than any other. We hope so. But what changes are we really talking about? Political? Social? Economic? All of them? Very difficult to say. Coalition will not be easy. President Dilma actually received 51.64% from the ballots, a new vote of confidence, but for the remaining 48.36%, Dilma's government lost credibility ... for the brazilian productive sector her "interventionism for good" hurt fiscal balance and the country's growth, for the markets as a whole and the country's fundamentals, the Economic Policy was relegated to the worst possible scenario. Her assistants, due to subservience or technical inability, succumbed to the political moment and led the country to the ropes. Ok ... the end justifies the means ... the election was won. Yes, President Dilma has another vote of confidence, but change is necessary... and fast change, because the bill has arrived ... those who call for change are rather concerned with social inclusion, but also with their business and prospects for the future. The adjustment must be made now, otherwise, a far greater effort will be necessary in the future, with no guarantee of success... the President must honor the vote of confidence and implement change, she is responsible for the first step ... we will all be together to support her, if current asymmetries are corrected.

On the international front, we saw more of the same: US economic expansion in earnest, Japan beginning its monetary easing, the Eurozone in political and economic trouble and China in the eternal "undefined" slowdown pace. Much volatility.

Thus, US Treasuries closed the month at 2.34%. S&P changed 2.32%, NIKKEI closed at 1.49%, DAX -1.56% to FTSE, -5.3%. In Brazil, the Ibovespa ended the month at 0.95% and IbrX, 0.95%. Maximum DIF15 11.27%, and for DIF17, 12.32%. NTN-B in 2050 ended the month at 5.97%, and the dollar (Ptax) at R$ 2.4442.

Economic Activity

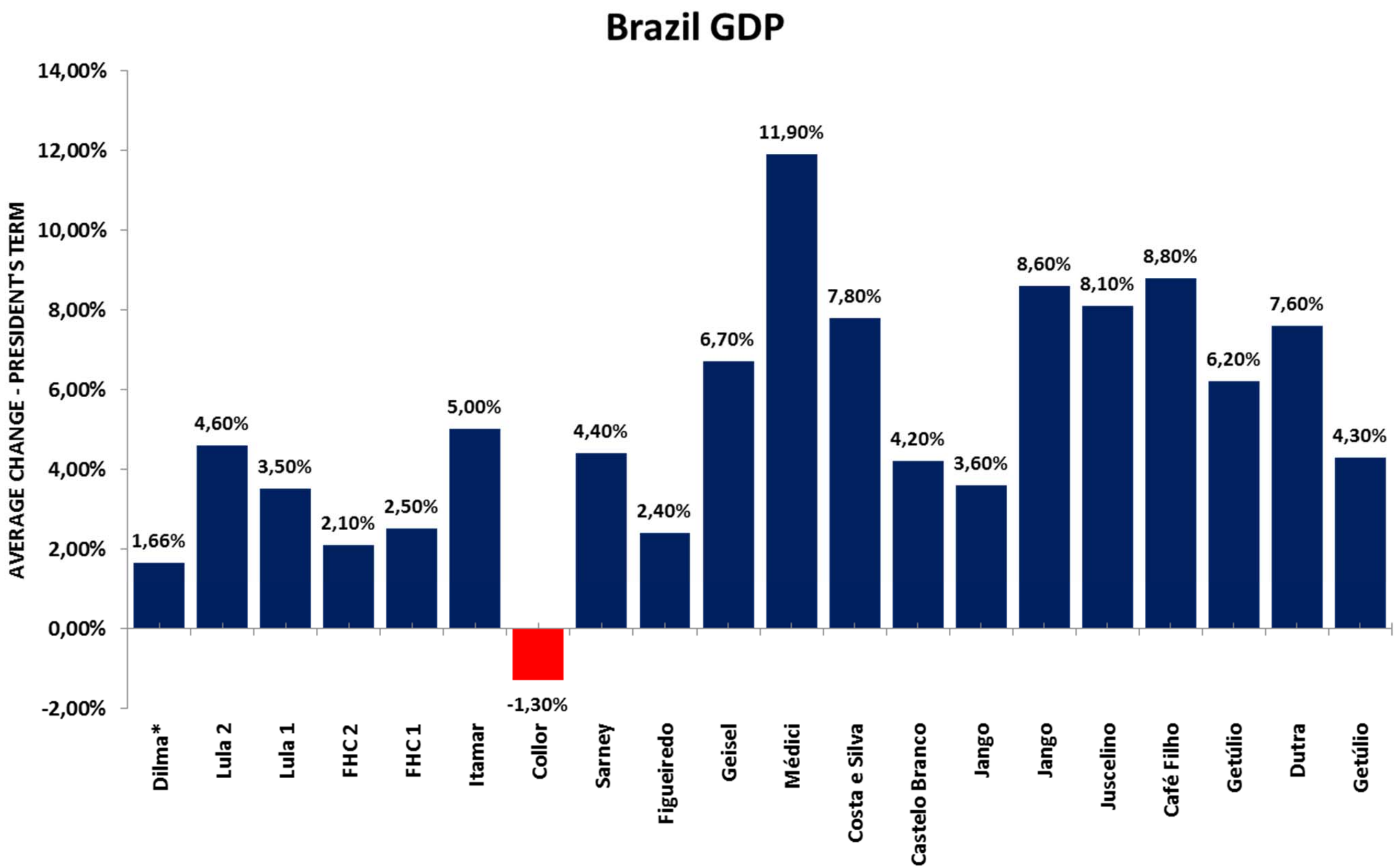
Our predictions, which since the end of last year were extremely pessimistic, now are possibly one of the most optimistic compared to the market as whole... go figure! Anyhow, our GDP projection of 0.49% is no cause for joy for anyone.

The low level of economic activity, a direct result of the implemented economic policy, would not result in anything different than what we're seeing. Actually we are victims of what has been coined by economists Rudiger Dornbusch (MIT) and Sebastian Edwards (University of California) as "Macroeconomic Populism". Indeed, these economists published a paper in 1989 entitled "Macroeconomic Populism in Latin America"... nothing difficult for us to understand because the so-called Macroeconomic Populism is an economic approach that **emphasizes** income growth and distribution and **de-emphasizes** the risks of inflation and financial deficit, external constraints and the reaction of economic agents to more aggressive non-market policies. Economists must show that political experiences in different countries and periods share common characteristics, (i) the initial conditions, (ii) the motivation for the policies, (iii) the argument that conditions in the country are different, etc., until total collapse at the end. The paper discusses the experiences in Chile (under Allende) and Peru (under Alan Garcia), and demonstrates that this policy is not a "correct affirmation" for a conservative economy, but rather, a warning that populist policies ultimately fail; and when they fail it is always a frightening cost to the groups who should benefit from it. That was written in 1989! 25 years ago. Is there some similarity to the present times? Venezuela, Bolivia, Argentina... Brazil?

We do not believe that, in general, rulers adopt such policies without having the "best of intentions". But we cannot underestimate the power of "lack of intelligence", mental rigidity or even stupidity (pardon for being inelegant). Add to that sleaziness, dishonesty/corruption and evil intent, and nothing comes close to stupidity (it's destructive!).... Nothing is more explosive than stupidity allied to power. Pure TNT!

We are confident that we will not continue experiencing Macroeconomic Populism, and harsh statements are only unsubstantiated conclusions that we are on the verge of apocalypse. The biggest fear is that there are no arguments against facts. The financial market, economists and economic and financial consultants project the 2014 Brazilian GDP growth to have an expansion of 0.24% and around 1% in 2015. The projected average annual GDP growth during the Dilma government will not reach 2%. No, it's not the end of the world but we must be careful, lest it will be the beginning of the end.

Economic Activity



Source: Ipeadata. Elaboration: Planner Redwood
**Forcast*

Fiscal Policy

The current Fiscal Policy can be interpreted as the "Age of Disorder".

Although "Eras" are described and identified only after they end, there is no doubt that the whole public accounts party allow us to pre-identify such an era. Expenditures grow at a rate of almost twice as much as revenues. The result of this month is the worst in history, and the most appalling is that we do not have a Plan B, or C, or D ... we have nothing!

Understandably, the economic team and the President herself are concerned with the "formality", the approval through Congress of a new surplus target bill for 2014 ... that's right, 2014! Two months from the end of 2014! Why? Because if they lose the vote, this would mean the Dilma's administration has failed to reach the target, signaling a lack of commitment towards the Fiscal Responsibility Law (FRL) ... this would not be less unfortunate, because, at any rate, it will not change our absolute state of shortages. Even more than this, we're talking about the past ... the past that has already impacted us and if we do not make immediate changes for the near future (and it will not be done with the approval of an adjusted budget), and the current dynamic is perpetuated, there will be strong consequences - among the most important, the loss of our Investment Grade status.

The possible approval of the new budget does not mean the economic team is getting its credibility back, even if it acknowledged the huge mistakes (which it does not!), because that would be an impossible mission. The deadline to do so has expired. However, with the renewed vote of confidence given by the Brazilian people to President Dilma it is not worth betting on this team. The best thing is to change all of them!

A new team might bring confidence, and credibility will be a mere consequence of a job well done without magic, with firmness of purpose and responsibility. We must enter into a new Era. It is time to put the house in order!

International Environment

Not even the rising US trade deficit for September was able to reverse the growth expectations for the US economy. Just to name a few important Institutions, JPMorgan economists estimate an expansion of the US economy in 2014 at 2.9%, while others, such as Goldman Sachs and Capital Economics, forecast 3% growth. Therefore, all is very much in line with our projections that ultimately, aims to holistically "draw" macroeconomic scenarios and correlate and evaluate the impacts on our economy and financial market. However, although we differ from the vast majority of the market (domestic and international) as to the FED monetary policy time changing - for us it will happen in the 1st half of 2015 (most likely 2nd quarter of 2015) while most expect it to be done in the 2nd semester of 2015. That makes a big difference as we've covered in this space.

In Asia, Japan "could not stand" and succumbed (somewhat, quite surprisingly) to the economist's "new fad", more clearly found in the US and stepped up "for real" its monetary stimulus program. In spite of the particularities of each economy, the timing and appropriateness of such policy, this path seems to dominate the political economic thought nowadays, one which alleviates the current pressure and pushes to the future the confrontation of real variables to be dealt with. It is a politically perfect economic way out, full of uncontested common sense justifications.

In Europe, economic conditions remain fragile. The European Central Bank (ECB) continues its stimulus program to boost the Eurozone economy, and its goal is to broaden its program. This is the third such ECB program (if we can count it) since 2009. The quantitative easing has less, and different impact than in the US, for in the Eurozone, firms rely more heavily on bank loans, while in the US the bond market is more widely used. The financial markets, however, are thankful. Who loses in the end?

Politically, the electoral U.S. Congress campaign took stage, and it seems elections will change the scenario, creating a Republican majority - a huge headache for President Obama, who is in the middle of his term. This political scene, however, should not impact relations with Brazil. It is expected - after all, that Democrats (more aligned with our current government) will remain in power.

Interest Rates

Said and done, Central Bank decided to act right after the elections. So much for Central Bank autonomy! Months after seeing things "falling apart", suddenly it figures out it is necessary to give a signal to the market ... but how does Monetary Policy and Central Bank Communications really work? How representative and practical is the effect of a 0.25% change in interest rates, especially at a running rate of 11%? The COPOM (Monetary Policy Committed) was divided, concerning the approval for raising the benchmark interest. Where the members wishing the increase more concerned with inflation **now** or the absurd (at this point) recovery of the unrecoverable (credibility)? Are the others, who voted against it, concerned with intensification of the already poor performance of the economy or focused (perhaps embarrassed by the sudden change of attitude towards the same scenario) and believing that only a new team will have credibility, and therefore, extract the most from Monetary Policy? It is not very difficult to answer...

The fact is that the Central Bank provided the service it is meant to provide, that is, obey the current leader ... as always - its autonomy is selective, specific, controlled and limited. The result is an extreme deterioration of the "credibility" component which empowers and enables (or, in the absence of, makes unfeasible) its actions. A strong, transparent and coherent Central Bank (at all times) issues powerful communications, is respected by the markets and optimizes its policies.

And so, the COPOM took the market by "surprise"... the Selic interest rate was raised to 11.25% after the presidential election decision.

The yield curve had disparate differents movements throughout the month. After the first round of presidential elections and pro market candidate Aecio Neves' advancing in the runoff, the reduced future interest rate curve premiums over all vertices had a negative slope, and a January 2016 contract was being traded higher than the January 2021 contract. After the election, the negative slope of the time curve ended.

Interest Rates

However, as polls indicated a greater chance of the incumbent winning the election, the yield curve started to accumulate premiums, especially in the short part, with projections indicating an increasing Selic at the last Monetary Policy Committee meeting of the year. Short term rates, at one point, priced the Selic about 200 bps by the end of 2015. The foreign exchange and treasuries movement have also influenced the interest rate market. The Treasury, at one point, reduced the size of supply of pre-fixed rate bonds at auction, to avoid greater volatility, while not sanctioning the higher returns the market demanded.

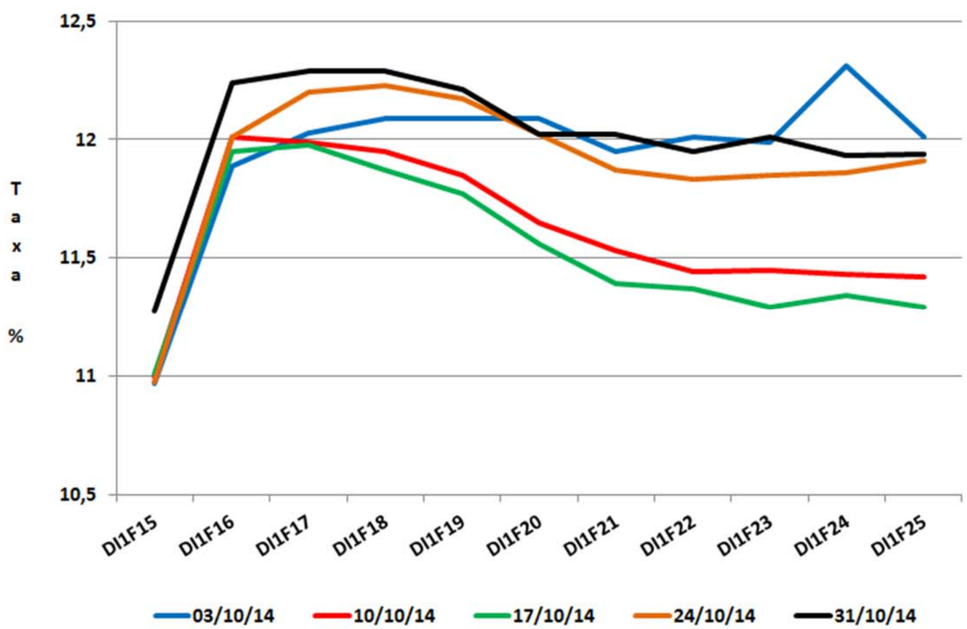
Dilma's victory in the polls and the September IPCA, above projections, caused the 12-month rate to accrue 6.75% raising a red flag for the Central Bank. The institution was "forced" to raise the basic Brazilian interest rates at 0.25% - this is the politically correct version for the moment. If, on one hand, the monetary authority is rendered guiltless for its inertia, on the other, hurts the others intellectually honest (not a few in its staff), who strictly monitor the real situation and need for action, with the best technical tools available, and are extremely annoyed by the situation.

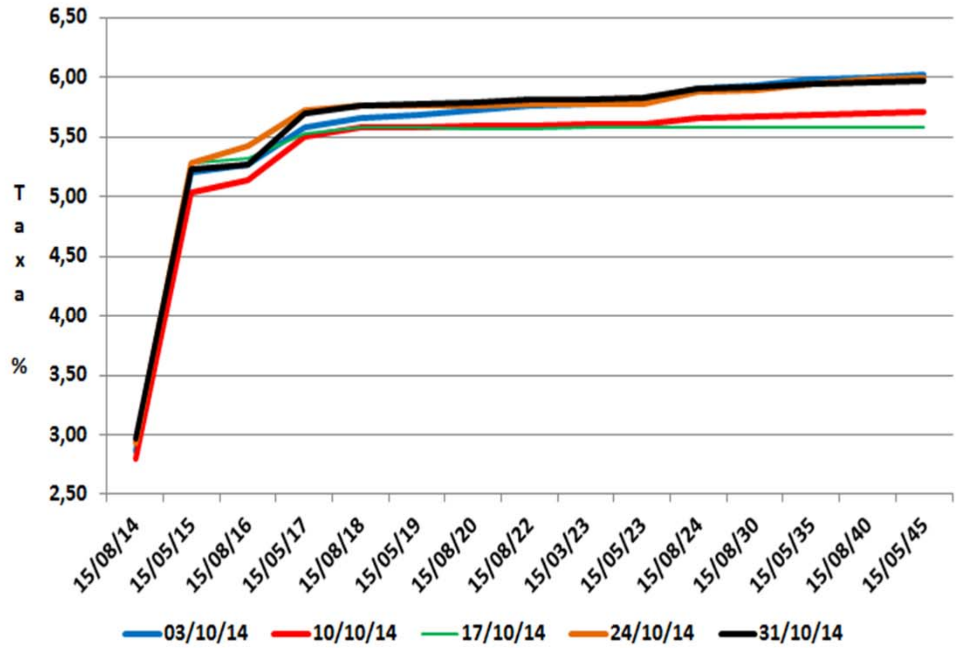
In terms of use of monetary policy mechanisms, the rising interest rates decision (Selic rate) by COPOM was a non-event. The next team (hopefully, it will take office as quickly as possible, and with greater autonomy, or at least with the strength to make technical components prevail) will have to raise the Selic rate at a higher pace/intensity and very soon ... that is, if it intends to reach the Central Bank's foremost objective: to be the guardian of the currency.

After the COPOM meeting, the movement of the yield curve rose the shorter vertices premiums and reduced the long ones, changing the slope of the curve. As for the NTN-B coupon curve, that followed the movement of the yield curve over the month, as shown on the charts below.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

As always, more of the same: Uncertainties concerning the management of new Dilma administration's economic policy raises the dollar exchange rate. This even challenges the main economic teaching: Supply and Demand Balance (at least in the short term).

In financial markets, however, between the first and second round of presidential elections, the expectation that the PSDB candidate could win the election, facilitating the restoration of credibility of the Brazilian economy caused the currency to trade at around R$ 2.37. But the movement of the real appreciation was short lived. The confirmation of continuity of the Dilma administration caused the currency to trade at R$ 2.56 the day after the elections, a level seen only in April 2005. However, exporter sales orders, due to the high currency level, the perception that the market had already anticipated re-election and raise of the Selic caused the dollar to retreat in the last week of the month. But as the financial market is deeply affected by short term and uncertainty environment hovering over the economy, and, in the last day of the month, (i) there was a disclosure of much worse than anticipated fiscal numbers, (ii) the formation of the Ptax and (iii) the stimulus measures announced by the Bank of Japan, triggered an adjustment in the foreign exchange market, interrupting the sequence of a falling dollar in the last trading sessions. Volatility was the word of the month!

In addition to the domestic factors that led to the appreciation of the dollar over the month, there were questions about the timing of the rise in FED rates, which also contributed to the loss of value of emerging countries currencies. Positive outlooks of recovery of the American economy can anticipate an upward movement, as we argue, despite the fact that FED leaders see weaknesses in the US labor market and work with lower growth rates in Europe, China and Japan, hurting US exports. Risk aversion around the world prevailed.

By all means, we continue betting on a broad overhaul of the team that leads the economic policy, calming down the markets and bringing the dollar to a level which is better aligned with the other variables. There has been a net currency inflow of US$ 6.9 billion, this month. The current level is not credible nor balance for/despite the moment.

Stock Market

Nothing is more sensitive and intriguing than short-term Stock Market movements. Trying to identify rationality in these movements is irrational! But, for long-term investors and particularly those focused on value strategy, these short-term movements (if not perpetuated for the long-term due to incompatible economic policies) do not skew strategies, and, additionally, provide good buying opportunities.

Thus, after the election the Bovespa (heavily populated by short-term players) left the negative figures, closing October with a high of 0.95% - a result achieved on the last day of the month. As in previous months, the presidential elections brought volatility to the stock market, with the difference that in October the expectations became reality, with the reelection of President Dilma. The result of the first round of elections on October 05, with the possibility of Aecio becoming president and leading the Brazilian economy in an orthodox path made investors happy. The Bovespa index returned to 58,000 points for over a week. However, as we approached the runoff and the chances of no change in power grew, investors opted to sell at the stock market. The week before the runoff the Bovespa accrued a drop of 1.5% in the year.

The President's situation may have improved, however new questions now affect market movements - the names that will compose the new economic team of the new Dilma administration. The profile of the nominees will define the new economic thinking, and therefore, the new guidelines and plans to realign the country's destiny. The government urgently needs to change! The possible loss of Investment Grade status, will bring massive impact not only to the interruption of flow of foreign capital for investments, as well as divestments - direct impact on business, and therefore, on the Stock Market.

The Stock Exchange's momentum on the last trading day of the month was mainly due to the strong appreciation of Petrobras and telephone companies TIM and Oi shares. With the tangled web of corruption and mismanagement of oil and gas price readjustment of the main Ibovespa company, Petrobras, the rating agency Moody's downgraded Petrobras' risk rating from Baa1 to Baa2, maintaining the negative outlook. The decision reflects the company's high financial leverage and the view that this will decrease (significantly) only after 2016.

The Ibovespa situation as a whole, in the eyes of the market and in light of the present scenario, is terrible. We need to be really selective, using tested methodology and qualified staff to identify and get the very best out of the situation. Without irrational short-term movements that may surprise us, this is the only rationale that works. Always.

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