Planner Redwood Asset Management

MONTHLY COMMENTARY

JUNE 2017

Monthly Commentary / JUNE 2017

Agenda

- Introduction
- Economic Activity
- Fiscal Policy
- International Environment
- Interest Rates
- Foreign Exchange
- Stock Market

Epigraph of the month... a propos of Brazil's current predicament.

"Our lives begin to end the day we become silent about things that matter."

Martin Luther King, Jr. – Protestant Pastor and American civil rights activist.

Introduction

What is going on in Brazil? Are we surrounded by innumerous agents and institutions destined to impose the continuity of the unprecedented crisis we are living? Is there artificial motivations and distorted politics in all of this or is the process running its normal course in exposing all of its inner workings?

What matters, practically speaking, is that on May 17, everything came to a “halt” under the strains of the last boiling scandal that assaulted the country. Uncertainty and perplexity has overtaken society in all its segments, with disastrous reflexes to the economic order in Brazil, particularly in regard to the urgently needed reforms.

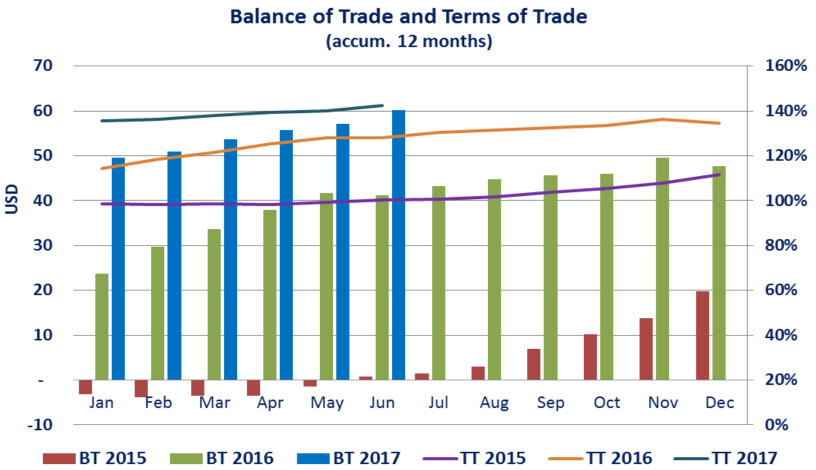
The grave political crisis has made room not only to demands to impeach President Temer, but also to reevaluate certain Constitutional rules. Both political parties in crisis and governmental institutions are mired in disarray and “stumble” upon each other – a confusion owed to a yet incipient, recent and “fragile” democracy – if we confine ourselves to the romantic reading of the situation.

In this landscape, we run the risk of deteriorating into a “gloves off” approach and “save yourself” behavior. And President Temer, praised here as a *Political Pelé*, has become, by design or by elaborate misguiding, in the pivotal character of the current plot… even former president Lula has “vanished” from the news. Situation parties seem ever more irreconcilable, in a flagrant frenzy and disorder to push forth important decisions to be addressed in Congress. If the financial markets does not denounce the coup as of yet, this is not to mean parting ways with politics – no way, sooner or later, a country dependent upon lawmakers to change the course of public finances, the formers’ ineptitude is bound to affect economic activity and the level of unemployment. This is all part of strengthening our democracy, bringing it all out to the surface, but the apathy and helplessness taking over the Brazilian population is quite worrisome. In truth, Dr. King’s assessment in the epigraph of this commentary sums up this worry quite well: *“Our lives begin to end the day we become silent about things that matter.“*

The world also had a troubled month, especially due to geopolitical issues. In the UK, all seems to lead to a soft Brexit, the Eurozone facing its unending dilemma of the ECB and its monetary policy, and China surprising the world by signaling changes concerned with “sound development” with the possibility of international agencies directly rating Chinese companies. In the US, six months of Trump administration have witnessed growing conflict with media which tends to outstrip expected measures.

In this landscape, the US Treasuries closed the month at 2.3037%. S&P varied 0.48%, NIKKEI closed at 1.95%, DAX at -2.30% and FTSE -0.71%. Ibovespa finished the month at 0.30% and the IBrX at 0.30%. Highs of DIF18 at 9.42% and DIF21 at 10.60%. NTN-B 2050 ended the month at 5.6435%, and the Dollar (Ptax sell) at BRL 3.3082.

Economic Activity



Source: MDIC I Elaborated by Planner Redwood

There is no doubt that the last scandal involving President Temer has had direct impact on investors' expectations regarding Brazil. It is also obvious that the political consequences of this fact on reforms and, consequently, on economic activity of (more certainly) this year and the next years (pending closure of the political crisis and impact on reforms). However, yet one more sign of resilience and potential stagnation of the economy have been brought to the fore, namely: a very robust balance of trade result. Despite sound criticism of such outcome (seasonality, mismatching of exports and imports paces etc.), the number is expressive: USD 7,195 million – simply de highest figure since the beginning of the series back in 1989.

So much for the good news. Following the plea bargain with JBS executives, such decoupling between economics and politics has set both its timing (few months) and effects (harmful, to say the least, if range of reforms is reduced) if the political crisis does not find swift closure. This does not seem likely, for corruption accusations are far-reaching and engulf significant share of the core political basis of the President.

This fact slowed down the momentum, active until May 17, to find solutions to our problems. Dwindling confidence indicators, fundamental to restore investments, revealed the urgent need to reverse this sentiment among investors – particularly foreign ones, which see total disarray in the country and a not a "Banana" but a "Super banana" republic – at the cost of further bleeding the economy until the next elections.

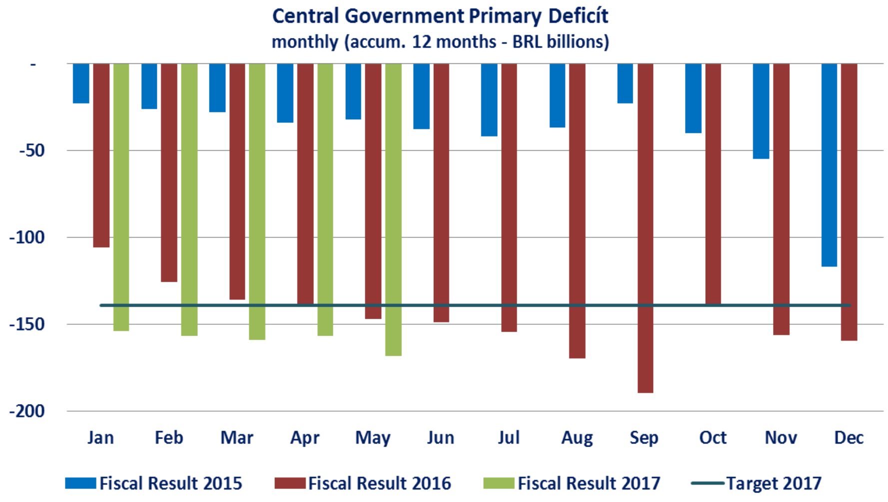
In this line, the economic team has done all it can and has become the cornerstone of the administration, providing some time to overcome the crisis, while the financial market still trembles… however, the real economy has priced already a good share of the political crisis: we will grow around zero this year and far short of potential in 2018… the solution to the crisis, in the next months or in elections in 2018, will show the pace of recovery for 2019, 2020…

In the limit, there is good news: it is hard to imagine a bleaker predicament than the current status. Thus, some sectors may bear good breath henceforth, such as agriculture (eternal savior of the Land), mining, the balance of trade itself with new forecasts, a controlled inflation (improving purchasing power), lower interest rate (improving credit and public debt servicing) and the unemployment rate that has stopped rising.

Well… not very convincing, but that what we have for now.

Fiscal Policy

It's out there for everyone to see!
The public finance disaster is flagrant. We set another negative record since the start of the series in 1997 in the overall result of the Central Government (primary deficit): BRL 34.98 billion this year! The result of the Treasury and Central Bank was a surplus of BRL 35.04 billion within the year until May, but far short of the required amount to cover the social security deficit, in the same period, of BRL 70 billion. In other words, this Central Government balance (Treasury, CB and Social Security) shows the gap between revenues and expenditures for the administration – nothing else – thereby exposing the crude reality.
The contractionary fiscal adjustment with a negative fiscal impulse of 0.5% of GDP to which we are subject to, according to Ministry of Finance, does not seem achievable or, unfortunately, is insufficient. The current arrangement of things and the situation point to the pivotal role played by reforms. The only alternative to enhance fiscal balance figures that is deeply tied to a stronger economic activity(one that is beyond the short term horizon), without deep cuts including essential services, will be tax rate hikes. Thus the goal for 2017 of BRL 139 billion primary deficit is, if we can attempt at a prognostic thus far, highly compromised. The Central Bank also presents a overall outline of Public Sector finances, including the federal administration, states, municipalities and state-owned companies (excluding Petrobras and Eletrobras), and the scenario is far from comforting: negative figures in the month and within the year – which corroborates that maladjustments are wide, general and unrestricted. The tidying-up breaks will have to be strong and immediate, so a snowball effect does not harm even further the next years.



Source: National Treasure I Elaborated by Planner Redwood

On the other hand, some members of the economic team say a share of economists is doing wrong math, notably regarding the Expenditure Cap limits. It may well be. Why not some more transparency then? No serious analyst wants to fight the numbers, for it usually doesn't end well. However, available (partial perhaps?) information shows mandatory expenses with social security will be growing at 8% (Budget Law) against the rate of 4% as stated in the Expenses Cap bill for 2018 (a limit rule tied to inflation)… the math does not hold. But if absolute differences are still meager for 2018, all else constant, things are likely to worsen very much in the next years. Thus, just like emergency water levels are discussed in times of drought, the concept and identification of the so called Fiscal Margin will be much debated soon ahead; an analogy fully applicable to the case at hand. Reforms immediately! Goal for 2017 without new taxes is out of question. We must think ahead.

International Environment

The world has grown a little tenser this month.

In the Arab world, Egypt, Saudi Arabia, Bahrein and the Arab Emirates imposed an embargo to Qatar for allegations of terrorist financing by the country. In North Korea, tests and threats of new ballistic missile launches, in a clear provocation, unnerved while uniting the Western powers around the issue that can escalate quickly. The American government does not believe China is doing all it can and, in the face of recent distress, the Chinese ambassador in the UN, Liu Jieyi, has alerted that escalating tensions with North Korea is bound to get out of control “and consequences can be disastrous”. For now, this subject has yet to affect world economies and finances… yet.

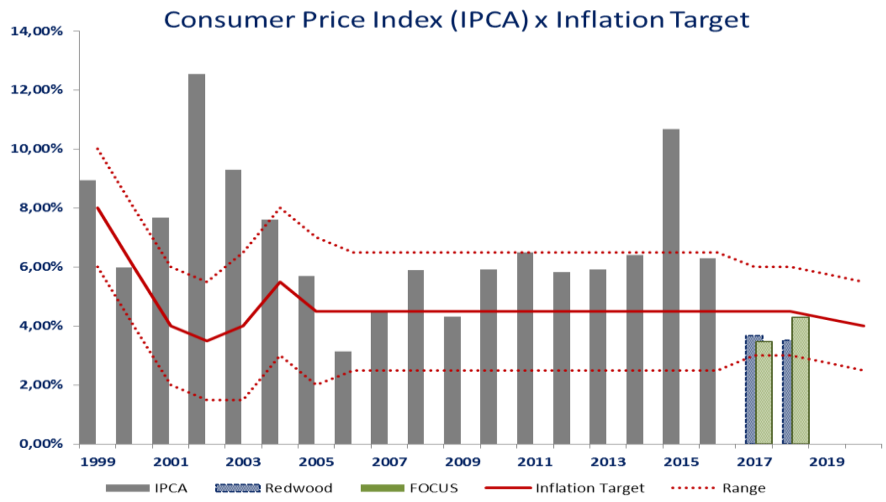
In the UK, following negative outcome for the Conservative Party in past general elections of June, where the majority of the House was lost, some officials are pressing upon Theresa May in many regards, but particularly against current austerity measures. Despite a smoother Brexit, the exit process from the European Union will be more challenging under les support for the Prime Minister. In Europe some good news regarding the PMIs Manufacturing released in June: highs in Germany at 59.6 (highest in 74 months), and in France (below expectations) at 54.8, while in the Eurozone it reached 57.4 (highest level in over 6 years) – and the best figure according to chief-economist at IHS Markit, Chris Williamson: “There’s no sign of the impressive performance ending any time soon. Optimism about the year ahead has risen to the highest for at least five years, backlogs of orders are building up at the fastest rate for over seven years and factories are reporting near-record hiring as they struggle to deal with the upturn in demand. As such, the manufacturing sector is clearly in expansion mode and looks poised for continued robust growth in coming months.” (IHS Markit Eurozone Manufacturing PMI Report - July 3rd 2017). This optimism contrasts with other data, for instance, the unemployment rate in the Eurozone, which has been stable at 9.3% in May (although the lowest level since March 2009) and de PPI that has registered a 0.4% deflation in May against April. In this context, all eyes are on the ECB’s next steps, but we at Redwood do not believe in drastic changes, especially when we analyze declarations by the institution’s chief-economist Peter Praet: “The mission of the ECB is not yet complete, the baseline scenario for inflation is based on the stimulus” (free translation).

In the US, President Trump carries on his rampage against the media (clearly a lose-lose situation) and attempts to see through his campaign promises – this month some success (approved by the House) the illegal immigration issue. According to the President, this matter represents “a crucial step toward guaranteeing public safety and national security”. In the economic camp, news is still good on the side of manufacturing, with robust indicators. In this vein, we maintain our perspective of another interest rate hike by the FED in 2017, reaching 1.5% by the end of the year.

Interest Rates

We have come to the end of the first half of 2017. In this period, short-term interest rates followed the downward trajectory anchored on the inflation expectations. The medium- and long-term rates were sensitive to political uncertainties.

We highlight the monetary policy announcement by the National Monetary Council (CMN) in June that the inflation target for 2019 and 2020 was lowered to 4.25% and 4%, respectively. The tolerance range was maintained at 1.5%. The novelty was that the CMN has brought a structural change by stretching the horizon to 2020, thereby signaling longer planning and the possibility of lower long-term interest rates and better accommodation of short-term shocks. Despite the target cut-down, Brazil is still above average in Latin America. Inflation projections indicate that the CMN could have been bolder, but has nevertheless opted once again for parsimony. The current framework of political and fiscal uncertainty has limited a sharper reduction. Inflation is projected to sit below target this year and opens up room for a more permanent and sustained interest rate cut-down.



Source: IBGE and Central Bank of Brazil | Elaborated by Planner Redwood

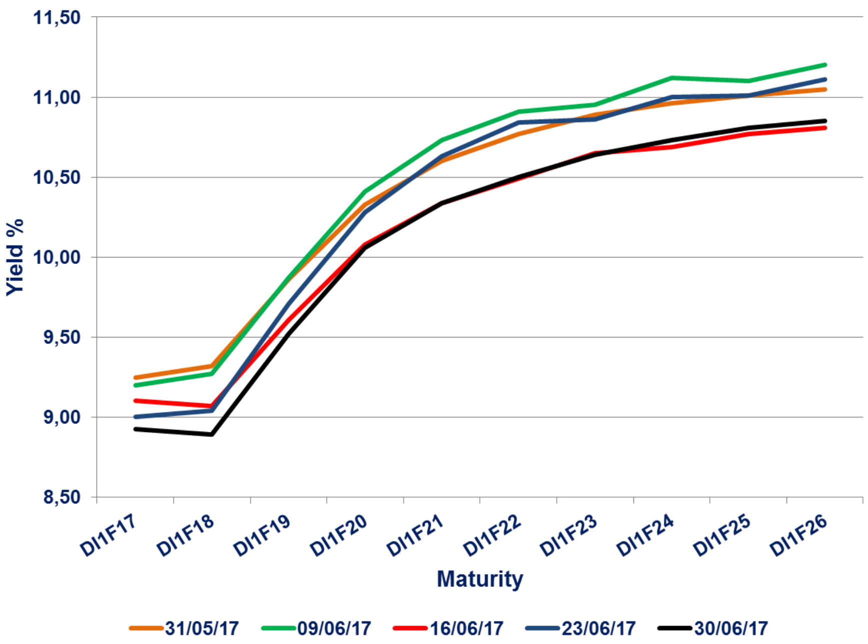
However, the ghost of inflation is not totally eliminated and, without prejudice to the notorious effects of interest rates on the level of prices, the rate cuts are also correlated with recession, the feeble aggregate demand, etc. Since the fiscal position in the country is highly imbalanced, should reforms fail to be approved or have its impacts reduced, the chief-debtor of the country will proceed paying out heavy interest rates.

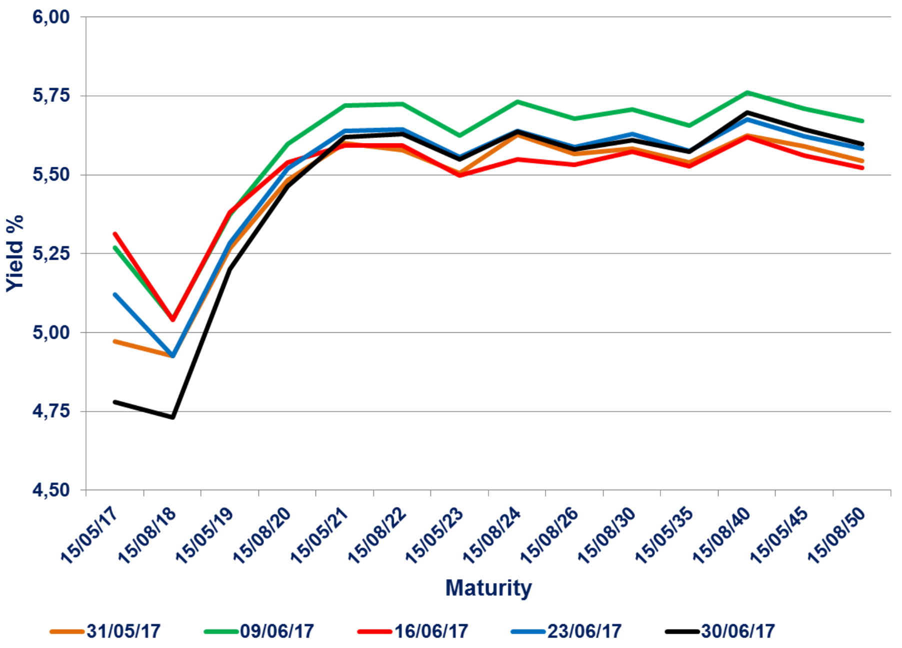
The financial market seems not to take the political crisis and the public finances in the country correctly into account, and the credits due are owed to the credibility of the economic team – but this unfortunately does not last forever and, if we keep at this pace, the horizon is far shorter. This is the reason behind the lingering fiscal and political crisis that will soon reach markets if nothing is done. It is inexorable giving the mutual dependence between fiscal and political.

The yield curve in the month had a reduced volatility when compared to the preceding month. Future interest rates devolved part of the previous high last month under the allegations against Temer. However, the slope of the yield curve (difference between short and long interest rates), an important measure of risk, it hovers above the observed level pre-scandal. Short interest rates keep on a downward trend, in line with our projections of a lowering SELIC to 8.5% in 2017.

Interest Rates

Yield and Coupons Curves (NTN-Bs)

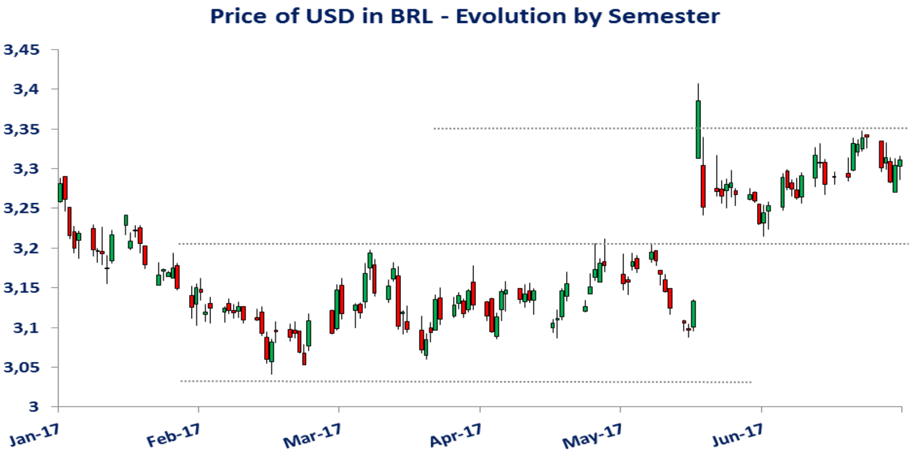




Foreign Exchange

The first half of 2017 ends with a change in the level of BRL trading with respect to the USD. The graph on the side displays two distinct periods of local currency quotes. In the first, the average trading price was BRL 3.14, reaching a minimum of BRL 3.05. In the second part, under rising uncertainties after May 18, the average price rose to BRL 3.29.

Even if this change owes to a global factor, with a coincident devaluation of a good share of emerging markets' currencies, in the case of the BRL the trigger was set off by the political scandal unearthed in May followed by uncertainty as to the continuity of approval of fiscal reforms and even of the President's term. In this sense, in quite an adverse scenario with longer delays or even without reforms and with deteriorating public finances, the current average will not hold. The fact is however that the market ***still*** has not taken this hypothesis seriously in its price setting decisions.



Source: Broadcast | Elaborated by Planner Redwood

Given its notoriety in anticipating and overreacting to certain events, why hasn't the market simply "changed" levels without overshooting, greater volatility in this recent period or more assertive signaling? Active measures by the Bacen with swaps? Of course not (no time for joking!) To ignore the political crisis, the reforms and the fiscal prospects has some basis, namely: (i) the economic team will hold, no matter what the situation is, the economic rationale already in place, (ii) external accounts, (iii) declining inflation, and (iv) foreign reserves (USD 375 billion). External forces also do help, a less hawkish FED already priced, an ECB with less willing to cut stimulus… added to the trillions of international liquidity, so everyone decides to stay a little longer in risky positions. In other words, could we be at a binary situation? Yes. Once the political crisis and the reforms have been duly addressed, the USD quotes is likely to retreat to levels projected three months ago.

As to the monetary authority's interference in currency markets, the Central Bank has concluded an integral rollover of the traditional currency swap batch maturing in July. Overall contracts amounting to USD 6.939 billion were stretched. Oh, this Bacen bunch really believes in what it does!

Stock Market

Even under all of the instability and uncertainty regarding the continuity of Temer’s administration, Ibovespa has closed the semester at a 4.44% high. In the month, the index has hiked 0.30%. Within the year, the Ibovespa reached 15.4% at its highest value in February. However, most of this rise retracted on May 18, when the index plunged to the 62,000-point level and has, since then, varied within the 60,000-64,000 range. Should the index drop below the 60,000-point mark a new momentum will lead the index down to 56,000 points – for starters.

It is worth highlighting Vale’s performance, which had a appreciation in the month and within the year due to booming iron ore prices and to the restructuring process that will lead the company to having only common shares. A positive structure for the minor shareholder that will also favor the reduction of risk of political capture of the company.

The word of the month among investors was caution, due to lack of predictability in the domestic landscape and to the paralysis of the already mentioned fiscal adjustment. In the first moment of the current political crisis, foreign investors opted to seize good opportunities in the Brazilian markets and bought shares, but in June the outflow dominated once uncertainties settled in the domestic scenario.

The beginning of the economic recovery in 2017 seems to have been left behind, and with the impact on the real economy its reflexes impinge on expectations, confidence indicators and also, of course, in the stock market index. If improving fundamentals take longer to set in (which seems to be the case), hiring and investments will be once again postponed, thereby reflecting the slow recovery and consequently affect the valuation of companies – which impacts directly the Stock Market performance through the companies that comprised in the Ibovespa.

On the other hand, although everything seems “halted”, at least the chaos that gained momentum (as it once happened in political crises) in the aftermath of the JBS plea bargain never took hold: (i) Temer still holds office, (ii) Congress is still working, albeit very slowly, (iii) investors have not abandoned the country despite shorting positions in the stock market, and (iv) inflation continues to surprise. This scenario has allowed some sectors to present positive outcomes in the first half of 2017, such as real estate and financial sectors which work on the assumption of a continued drop of interest rates that boosts demand for credit and, therefore, the resumption of growth.

At last, the Stock Market is no place for amateurs; selectivity and expertise based on personal experience or on structured and tested models are necessary conditions, albeit not sufficient, for a continuing success. In truth, active management in rule comes at a very high cost… in all senses of the term.

Monthly Commentary

JUNE 2017

3900. Brigadeiro Faria Lima Avenue. 10º floor
CEP 04538-132 São Paulo – SP
Tel. +55-11-2172.2600
Fax. +55-11- 3078.7264
redwood@planner.com.br
www.planner.com.br