Planner Redwood Asset Management

MONTHLY COMMENTARY

MARCH 2017

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

“I walk slowly but I never walk backwards.”

Abraham Lincoln – Former American President

Introduction

Following festivities, the year has finally begun following in March, all eyes turn to what matters most in Brazil, namely: the reforms, in particular and most important of all, Social Security.

On the international front, this is an extremely delicate subject and invariably quite controversial, for it touches people's lives directly on their main goal, that is, a peaceful and financially stable retirement after years of working life.

Thus all society tends to get involved and varied takes on social security emerge, starting from conceptions, principles and goals of retirement, up to the sustainability, contribution and maintenance of the system. Here in Brazil the patterns holds up; not so much when it comes to tackling the problem, and worse, it has been aggravated in recent years, putting us in a limit situation, and this might be the last chance to find a solution without major compromises.

Our predicament is highly complicated and under the extreme politicization of the subject tied to the fragile economic and political situation of the country, several assertions regarding the veracity of figures are presented and even the way they are computed. All of this aims at reinterpreting or reconfiguring a disaster that has taken hold and points in a short period toward a total and definitive collapse of public finances and of the country's budgetary management. Can the proposal presented be in any way upgraded? Yes, and so it must. A discussion of its details is required, but one cannot falter on the big picture, much less in making concessions that may well undermine a definitive long term adjustment. If the numbers and their consolidation fall short of convincing, the government should (and quickly so) propose an "independent audit", but if social security reform becomes one more patchwork, retirement payments and pensions soon will take up the entire budget – or, as seen in other countries, lead to cutting back on these expenditures. Therefore, enough with backlashes! The quote by Abraham Lincoln is truer now more than ever: *"I walk slowly but I never walk backwards."*

Turning to the world, we see Germany and the Eurozone showing off an increasing PMI Manufacturing and a lowering unemployment rate, with the exception of the United Kingdom where the former has dropped and hence a re-evaluation of its economic activity is under way. The ECB is not open to discuss tapering its monetary expansion based on the understanding of the adequacy of such policy. In politics, French presidential candidate Marine Le Pen leads the race in the first round. On the other side of the Atlantic, Donald Trump faces hurdles, however momentary, to implement his campaign promises. The FED signals repeated hikes in interest rates, but claims domestic finances do well. China waits to assess its relationship with the new American administration.

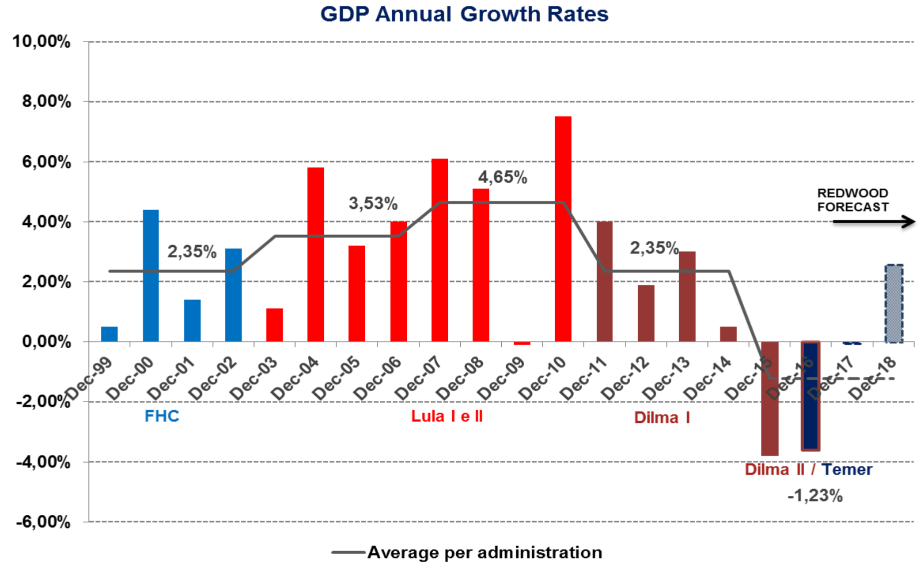
In this landscape, the *Treasuries* of USA closed the month at 2.396%. S&P varied -0.20%, NIKKEI closed at -1.94%, DAX at 4.31% and FTSE 10.20%. Ibovespa finished the month at -2.52% and the IBrX at -2.36. Highs of DIF18 at 10.32% and DIF21 at 10.21%. NTN-B 2050 finished the month at 5.19%, and the Dollar (Ptax sell) at BRL 3.1684.

Economic Activity

The legacy of ineptitude of PT presidents, above all with the infamous New Macroeconomic Matrix, has led Brazil to this bleak situation, with more the 13 million people unemployed and a weak perspective of a gradual upswing and, unfortunately, without no guarantees that we will not have any bumps along the road.

The statement made above is couched on the wide-ranging, general and unbounded misgivings. Yes, Brazil has reached a limit situation, where adjustment relies fundamentally on the absolutely unpopular reforms. In this vein and notably due to the political situation that has engulfed the current administration – with staggering low levels of popularity – difficulties abound on the way to approve such adjustment in a timely fashion. Adding to this, some “politicians” seize on this situation to act in self-serving manner – and, behold, including those who have put us in this predicament.

Much has been done in terms of economic policy, but the reconstruction is shown to be ever more difficult and, as always remembered, dependent on the facts and on the political will to reach a long-term solution.



Source: IBGE and Redwood Forecast | Elaboration: Planner Redwood

Therefore, even with some signs of improvement, a host of diffuse indicators does not yet support we have embarked on a route of recovery, but at least it seems that worsening has come to a halt… but it only seems like it. Any bump, political, economic, financial, external or otherwise, together or alone, has the power to destabilize the flimsy balance we enjoy.

Any scenario we formulate, under various premises, but within reasonable facts (i.e., without major shocks), points to a GDP growing near zero in 2017 – with a meager variation, even with a more drastic drop of interest rates (SELIC), due to lags in the transmission of monetary policy effects. In this line, average unemployment also takes time to react significantly and is likely to present, along with economic activity, consistent improvement only in 2018.

Fiscal Policy

No end in sight for fiscal adjustments.

Last figures released point to a BRL 60 billion gap. The current government has done a lot in trying to reverse the nonsense inflicted by the previous administration, but we have reason to believe that measuring and predicting revenues and expenses have eluded the economic team.

It is understandable that the government should not breed pessimism, quite the contrary, but constant signaling by numbers that never come to fruition and result in reassessments with undesirable impacts and consequences – such as possible tax increases – do not help a bit in forming expectations.

At any rate, this is the ghost that haunted us in March that, despite being cast away at the end of the month, is not unlikely to come back and scare us in the near future. Tax increases are not good at all, particularly in a moment of weak activity when firms do not hold up to their fiscal obligations. The tax burden needs to be elevated by the total reversion of benefits wrongly conceded by the previous administration. The way business is conducted now is correct, for it realigns the necessary adjustment of tax rates and eliminates serious distortions – and their multiplier effects – entailed by the previous tax-relief policy.

The fact is that a “new” deficit imposes necessary cutting back, after all the government is certain to achieve its target, no matter at what cost. It is a good sign to reaffirm its promises, but it would prove better to not overburden the population… this takes us back to the point of efficiency/alternatives frequently addressed in the report regarding fiscal policy guidelines.

In this line, despite efforts attempted, fiscal results in the first two months were a total disaster. The gigantic gap in social security seals our destiny: figures do not balance out, we need a reform and beyond that much effort to secure results in the long run. Primary deficit (ex-debt servicing) has decreased by half in the first couple of months, when compared to last year’s figures for the same period; credits go to the Treasury, were it not for the Social security gap that ended the party.

On the other hand, the general outcome for the public sector (states, municipalities and state-owned companies – except Petrobras and Eletrobras) was a primary deficit, a picture that is far worse when we look at the nominal deficit: BRL 54 billion in the first two months and BRL 536 billion accumulated in 12 months, taking up approximately 8.5% of the GDP in the period.

Adding harm to foul, our calculations predict the Gross Public Debt is already greater than 70% of GDP – comparatively to other emerging markets we are far from well. We must tread ahead, with the agenda under way and in a more daring and determined fashion.

International Environment

Except for the United Kingdom, mired in turbulence due to the special BREXIT moment, various European countries and the Eurozone itself have issued positive signals. We can highlight, to a some extent, inflation and PMI Manufacturing both escalating and the decreasing unemployment rate (lowest since May 2009) – far from comfortable, but a rejoice nonetheless. If on one hand it does not represent any relief (the Euro and European unity are still under threat), on the other Europe is under terrorist siege, unfettered immigration and an endless situation of fiscal imbalances among nations. The growing "populist" right-wing movements in the continent has suffered its first setback in Dutch elections, where anti-immigration, anti-European Union (EU) and anti-Islam polls-leading runner-up Geert Wilders was not elected. But also the Labor Party candidate failed to win electoral majority (a historical defeat), having the country elected the conservative Mark Rutte – a liberal, but tough on immigration and pro-EU. The next big events of this nature will come from France and Germany, in April and September, respectively, and will set both the political tone and direction for the European block.

In US signs are of continuing improvement: inflation converges toward the target and the labor market comes close to full-employment – 4.7% unemployment by US standards. Due to this, and in great measure, we believe, to Trump's promises of increases spending (infrastructure pack may reach USD 1 trillion), the FED is likely to continue driving up the interest rate twice or more this year… far past due time. Still on the financial side, reform of the Dodd-Frank regulations is anxiously awaited. The law was created in the wake of the 2008 crisis *to limit risks and enhance transparency and accountability*, but the end result was onerous regulations to financial firms and above all severe limits to options enjoyed by consumers of financial products – a strong intervention in the country of opportunities where each one is responsible for his/her own decisions. In politics, Donald Trump has faced tremendous hurdles to live up to his campaign promises and even holding up the nominees to compose his cabinet. This is not surprising given his stands in opposition to the establishment left by the Obama administration and the political divide that marks the country. There is nothing like a country with a solid democracy and strong institutions to find a way for opposing forces to come to good terms.

In Asia, attentions turn to US "ties" to China and Japan. The latter has met with the American president and reached satisfactory results, but the more delicate situation regards China in the face of several attacks and accusations made during Donald Trump's campaign. China and US make up 40% of the world economy and a misunderstanding between the two may trigger not only economic problems with literally global impacts, but also of a military nature, as in the case of North Korea.

The United States "command" the destiny of most lives in the world, for better or for worse… important changes are under way. Globalism and globalization are two things apart – this is a clear message that the new American government is keen on passing on.

Interest Rates

Frist quarter 2017 has come to an end. The economic landscape seems to clear the mist, however cloudy remains the political realm (with its economic impacts). Expectations point to lower interest and inflation rates. On the other hand, optimism regarding social security reform (as it was originally conceived) is fast losing ground. The Superior Electoral Courts (TSE) is assessing the indictment of the Dilma-Temer platform for illegal campaign donations in the 2014 elections. The government has been under friendly fire. Meanwhile, public finances persist in the red, without mentioning the release of details of the plea bargain made with Odebrecht. And even in this scenario of political unease the yield curve has lowered premiums, prevailing the economic scenario.

Investors are limited and focused on the plunging SELIC rate. As long as the Central Bank signals with the possibility of speeding up cut-downs, every other risk is set apart. Market bets are on a 100-b.p. cut in the April meeting of the Copom. This bet was reinforced by the release of the Quarterly Report on Inflation (RTI) which shows inflation to be under control. The Central Bank seeks to reduce interests in a structural fashion, especially now that anchoring inflation has become a “sure thing”. We are quite prudent on this matter, predicting the maintenance of 75-b.p. cuts , notably on account of uncertainties undergirding the political stage with direct and immediate effects of the formation of expectations in the country. We are confident, but very cautious, on the advancement of reforms.

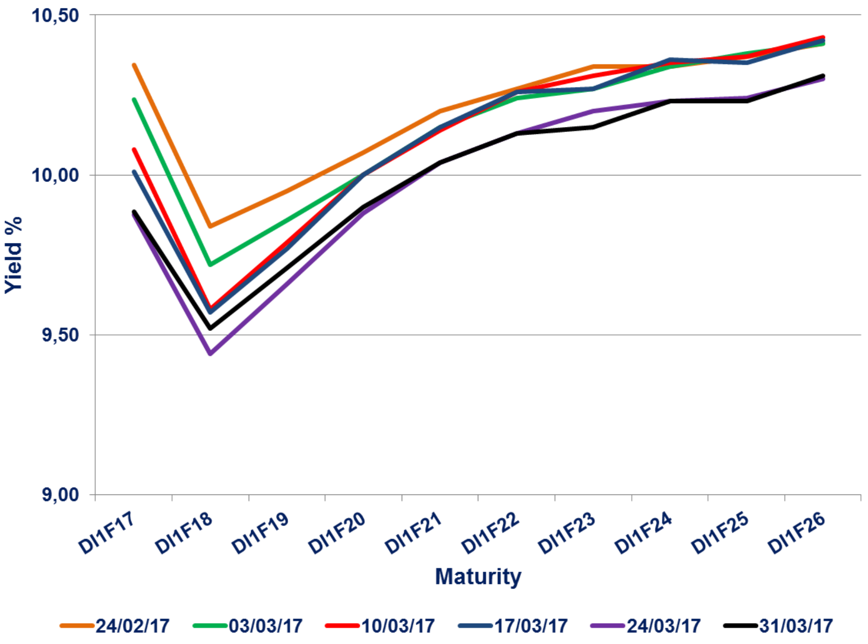
At the end of the month the government announced a plan to replace, within five years, the Long-Term Interest Rate (TJLP). Thumbs up for the government! The TJLP is the rate of reference of the long-term financing by the BNDES and the government, applied to subsidized credit that is believed to distort credit markets in Brazil thereby contributing to increase interest paid by those unsheltered by government subsidies. Nowadays, the gap between the TJLP and SELIC is of 5.25% yearly. Following its replacement the cost of money is likely to go down or at least to become more homogeneous across the market. The problem here is exactly the lengthy transition, that is, it will take too long until loans already in place are reverted. At last but not least is how this new interest rate will be determined, which takes in consideration the rates applied to the NTN-B, whose volatility is far from negligible.

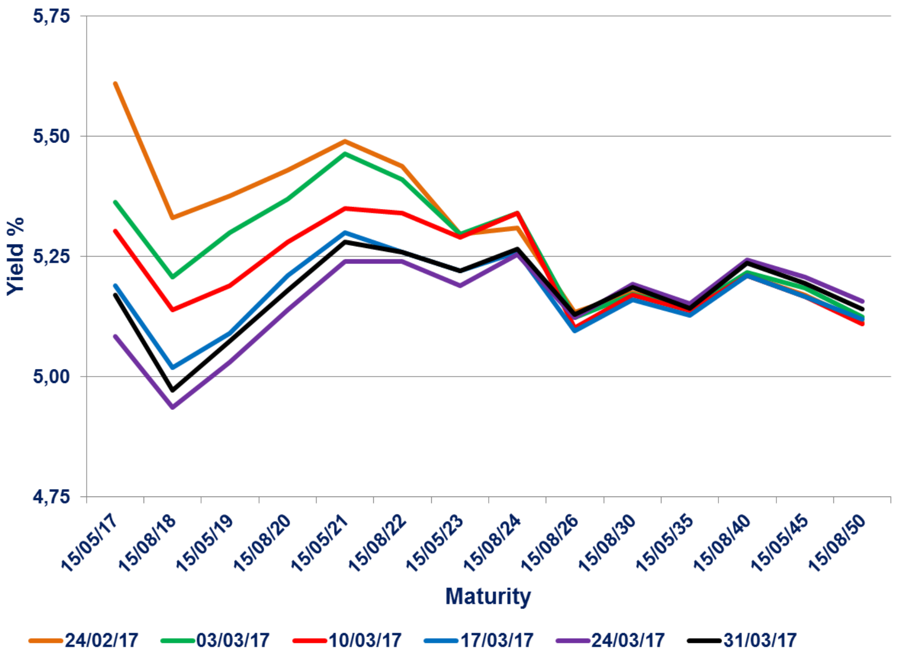
Amidst all of this, it seems as though monetary policy has been well conducted. The credibility enjoyed by the Central Bank chairman, the quality of its team and the communication of the institution with the market have all been well placed. This understanding has led to a landscape of predictability, crucial to the well functioning of markets. If monetary policy is central to restoring economic activity, it cannot deliver much mileage, in the medium and long runs, without the “support” of fiscal policy, microeconomic reforms and efficiency and productivity gains. Thus the counterpart to the Central Bank’s contribution to the whole may well be transient without complementary measures, considering its intrinsic responsibility in maintaining a solid and efficient financial system.

The liquidity and movement of the yield curve in the month were toned down with minor variations in prices when compared with previous months. A similar movement occurred in the coupon curve of the NTN-B.

Interest Rates

Yield and Coupons Curves (NTN-Bs)





Foreign Exchange

The Dollar accumulated a 2.23% high (Ptax sell) in the month, reaching a 2.78% devaluation facing the BRL within the year. The US currency has ranged between BRL 3.05 and BRL 3.20 in the last months.

For a month filled with news such as: (i) pressures arising from the FED's decision to hike interest rates, (ii) the new Trump economic policy, (iii) expectations of the plea bargain of Odebrecht and (iv) Justice Department's probe into the meatpacking market ("Operation Weak Flesh"), the USD has wiggled a bit. A lower volatility of the currency shows that investors are setting apart, momentarily, the economic and the political questions. Still, as mentioned above in the interest rate section, the tweaking and/or non-approval of the Social Security Reform may elevate the pressure on the BRL.

Amid the ups-and-downs of the currency swap operations, March proved to be a negative month for the Central Bank. The institution faced losses with these operations amounting to BRL 1.24 billion. The stock of swaps is close to USD 19 billion, against its previous level of USD 100 billion. In April, the rollovers reached 57% of contracts maturing within the month. The Central Bank has yet to ascertain its strategy of partial rollovers, but it all points to the same line of action… who knows?

Swap operations have a fiscal impact. Gains and losses are allotted in the interest account, with subsequent effects on the nominal deficit. A reduction of the stock of swaps in 2017 is likely to make variations less significant to the behavior of fiscal variables – at least in part, and in this situation. In truth, if there is any fragility to be ascribed to the current team at the Central Bank is that it is keen on exchange rate policy. However, even in this aspect there is a caveat: the legacy inherited from the previous board is not a easy burden to carry, and hence it will take some time to clear out. The issue is how fast such an adjustment is intended to be done with until there is little or no influence by the institution – that if they in fact believe in it. Besides that, constant interference in the market is all that is to it, no. The major problem harks back further, for the monetary authority's assets have increased substantially since 2007, especially between 2007 and 2011, with a strong foreign reserves buildup. The latter now responds to approximately 20% of GDP, a significant value that has relevant impact in the face of Act 11.803 of 2008, which determines that gains and losses accruing from appreciation/devaluation must be supported by the National Treasury (TN). However, there is an asymmetry in the currency equalization form of payment, for the gains are deposited in the cash account of the TN and the losses, in bonds at the Central Bank. Ok, what does the exchange rate policy has to do with it? Everything. We must improve the mechanism of the Law, enhance our structures so that the exchange rate does not become a ghost and let the market tell us where to go.

In the final analysis, the lowering of stock of swaps matches buying Dollars and, should Brazil move forward on its reforms and the world is free from future major shocks, we will be on the forefront (at least in relative terms, as already mentioned) with a lower CDS and a strong inflow of Dollars. We must quickly set straight all the aspects mentioned above so we won't need to fix the plane in plain flight.

Oh, in time: all is running according to the script, chances are strong that the Dollar will go below BRL 3,00.

Stock Market

March has been a month of realizing profits for the Ibovespa: 2.52% drop. Foreign investors have sold their positions in the market and there was an outflow of capital. However, returns scored positive within the quarter: 7.90%.

The recovery anticipated by the market for the beginning of the year is likely to be postponed – which falls in line with our previous predictions. In January, the main sectors of the economy remained on the negative side. Manufacturing output was disappointing in February, with a 0.1% increase against January. The trend reveals damage control mode, but nothing guarantees the restoration of growth. If the economy does not react, the Ibovespa may follow suit.

With a lesser impact than initially estimated, the “Operation Weak Flesh” launched by the Federal Police has entailed losses to the firms involved, to the sector and to the image of the country abroad. For instance, from the report of the probe to the closing of the month, JBS shares plunged 14.10%. The government managed to act fast to contain the more severe effects in the international market and reverted the embargos put in place by the EU, China, Hong Kong and South Korea.

Despite its nefarious effects on the general perception of Brazil, the probe fail to affect the conduct of macro policy. Brazil relies on private investors, especially foreign, to finance its traverse out of the recession and back to economic growth. An example of the need for foreign capital was the concession of public utilities, such as the four airports, to foreign groups. Lacking credibility was shown in the absence of interested investor in the auctions. Only three groups competed for 4 airports. Only foreign competitors took their place in the auction, which signals the dependence on international capital following the Car Wash Operation, which has engulfed all the major construction firms in the country. Events such as the “Weak Flesh Operation”, which could have been conducted in a more discrete manner, act only to smear the country’s image abroad. In this line, the Investment Partnership Plan (PPI) is crucial to boost growth since the Brazilian government lacks the resources to invest in infrastructure, but it will only gain momentum once the political crisis clears out. All of this affects the Brazilian stock market.

On the economic side, the more intense and faster drop of interest rates (tied to the reforms and other measures) will be determinant to the pace of economic recovery. Investments will probably come back to the agenda of firms that survived the crisis (and especially the deleveraging of their positions) and thus will have a more efficient cost structure and will be more productive.

It is quite likely that the Ibovespa, as other indicators, show signs of significant improvement in the second half of 2017, with the approval of reforms, the definition of the international scenario (Trump and elections in Europe). After all the Brazilian stock market, measured in USD, is simmering 78% below its maximum score in April 2011, and 120% above its recent minimum (January 2016) with a P/E ratio around 13.9%.

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