Planner Redwood Asset Management

MONTHLY COMMENTARY

NOVEMBER 2017

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

"Attitude is a little thing that makes a big difference."

Winston Churchill – former Prime Minister of the United Kingdom

Introduction

Timing is everything!

Timing is a quite elusive thing, but it can make the whole difference for expected results. This is the situation we are living nowadays as we try to convince society and our lawmakers as to the urgency of Social Security reform, whose time has come.

The cost of losing such timing, under various and most bizarre pretexts, will legate a huge burden and will impose a reform yet more rigid and in a shorter timespan. Yes, retarding the approval of this reform in the next six months will lead, unequivocally, to the transference of this responsibility to the next presidential term, for starting in April 2018 there will be no more room for talks of this nature – the 2018 presidential race will hog all the attention.

Therefore, we don't mean to sound catastrophic, rushed or anxious, but against facts (numbers indeed) there are no arguments – be it by dissenting accounting rules, tax collection "failures" or imbalances, the budget simply is not enough. The very concept of budget constraint is not hard to grasp, but impossible to translate into practice if its consequences do not implicate the ones generating it in the first place. Serious economists, rating agencies and the financial markets issue clear signals as to the growing need of the "Reform of all Reforms", with clear movements of stress every time the risk of now passing the reform appears on the radar. In this sense, we do not yet know if a plea for our lawmakers conscience or sense of duty will make any difference, but maybe this bond proves to be the only thing left to try and associate to each one's particularities and positions, with a consequence in the upcoming elections. Our congresspersons must take the republic stand. Social Security Reform will never form consensus anywhere, but as Winston Churchill once stated: *"Attitude is a little thing that makes a big difference."*

In the world, tensions are back between US and North Korea – few times have the US been so patient in a situation like this… and diplomacy strides fast toward failure. In Europe political temperature is rising in Germany as a broad and new coalition government is sought, and in the UK the prime minister under a lot of heat at home to carry Brexit all the way through. In China, its expansionism is almost a shove in the face of what goes on in the world. Xi Jinping's speech to the country is clear: "being a global leader in terms of power and international clout", given the "advancing multipolarization – which is changing the world order". Now, is it really? US contest it to stay on post.

In this landscape, the US Treasuries closed the month at 2.4097%. S&P varied 2.81%, NIKKEI closed at 3.24%, DAX at -1.55% and FTSE -1.87%. Ibovespa finished the month at -3.15% and the IBrX at -3.38%. Highs of DIF18 at 7.218% and DIF21 at 9.52%. NTN-B 2050 ended the month at 5.4500%, and the Dollar (Ptax sale) at BRL 3.2616.

Economic Activity

Brazil's GDP has grown 0.1% in the last quarter (QIII/QII).

Objectively, in general terms economic activity was nil! Was it? It is possible that the glass is half-full instead of empty, not by any naïve or biased optimistic voluntarism, but by factor decomposition analysis of GDP. The table below depicts this:

GDP	QTR rate of growth (on previous years's equivalent quarter)			Quarterly rate of growth (on previous quarter)			Accumulated within-year growth rate		
	3 QTR 2017	2 QTR 2017	1 QTR 2017	3 QTR 2017	2 QTR 2017	1 QTR 2017	3 QTR 2017	2 QTR 2017	1 QTR 2017
GDP	**1.40**	**0.40**	**0.00**	**0.10**	**0.70**	**1.30**	**0.60**	**0.20**	**0.00**
Agriculture	9.10	14.80	18.50	-3.00	-2.30	12.90	14.50	16.70	18.50
Manufacturing	0.40	-1.90	-1.00	0.80	-0.40	1.20	-0.90	-1.50	-1.00
Construction	-4.70	-7.10	-6.40	0.00	-1.90	0.10	-6.10	-6.70	-6.40
Services	1.00	-0.20	-1.60	0.60	0.80	0.30	-0.20	-0.90	-1.60
Retail	3.80	1.00	-2.50	1.60	2.20	0.20	0.80	-0.70	-2.50
Real Estate	2.10	0.90	-0.50	0.90	1.30	-0.40	0.80	0.20	-0.50
Household Consumption	2.20	0.60	-1.70	1.20	1.20	0.20	0.40	-0.50	-1.70
Government Consumption	-0.60	-0.80	-0.50	-0.20	-0.10	-0.10	-0.60	-0.60	-0.50
Gross Fixed Capital Formation	-0.50	-6.70	-3.70	1.60	0.00	-0.60	-3.60	-5.20	-3.70
Exports	7.60	2.50	1.80	4.10	1.20	5.70	4.00	2.10	1.80
Imports	5.70	-3.20	9.80	6.60	-3.40	1.90	3.90	3.00	9.80

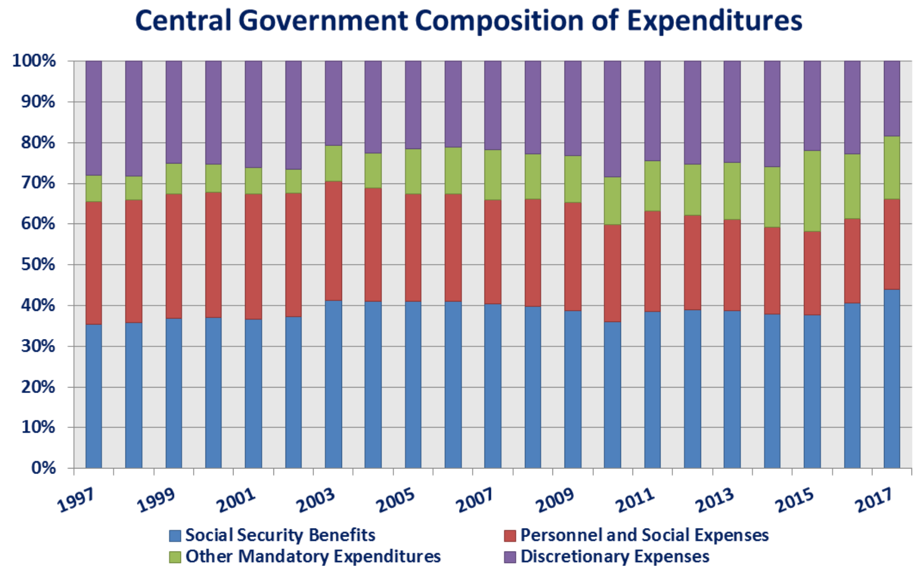
There's no doubt that recovery is much more sluggish when compared to similar moments in the past… no wonder, we are coming out of the worst recession in history. However, the 1.4% GDP growth in QIII/2017 on QIII/2016 is the greatest on this benchmark since QI/2014. Besides, were it not for the terrible performance of Agriculture in this last quarter, we would have had a GDP growth rate around 1%. Therefore, the criticism must stop there when it comes to this sector, for it is this very sector that has led Brazil's growth this year with overwhelming rates! Upon closer inspection, on the supply side, Manufacturing stood out in the QIII, while Household Consumption has had its third consecutive growth. In this line, we observe what matters most when it comes to economic activity: job creation. Unemployment rate dropped to 12.2%. Real wage bill has grown on the tracks of rising occupation, but it was foremost influenced more by the mismatch between the pace of inflation and that of labor compensation than by job creation itself. In this moment, the rise in employment seems to have been more significant than real income. The expansion of real wage bill was enabled as much for the rise in individual gains as it was for the increase in the number of employed persons. Therefore, we are optimistic and, insofar as our models project a more modest GDP growth for 2018 in relation to the market, we also differ from the traditional correlation of GDP growth vs. Employment Survey data (PNAD). In 2018 we expect unemployment rate to fall to one-digit levels.

Fiscal Policy

Some say that the voice of the people is the voice of God.

Despite our optimism with the economy and job creation, this feeling is based on our premise that Social Security Reform will be approved – disfigured or not, we trust it will pass. This would be a republican attitude, but it has to happen right away (or until April/2018), so we can take the “first step”. Yes, no reform of such nature would come out as originally planned, and one must bear in mind that we’ll have various reforms until we achieve the ideal one… but, we need such an attitude now to signal the commitment and the importance that the situation requires.

Nonetheless, the optimism by Brazilians in relation to the economy’s performance has had a significant drop and reached the lowest point in November for the last eight years, according to the data series compiled by Ibope, a private poll company. Could this be the voice of real identification on where we are? Without the approval of Social Security Reform by the House of Representative still in December or, in the next six months at the latest that precede the boiling presidential race, all can change quite drastically.



Source: National Treasury | Elaborated by Planner Redwood

With accounts out of control, inflation, interest rates, economic recovery and job creation, recent achievements after so much trouble will be on the line. A belated Social Security Reform, which is an essential piece of the overall fiscal consolidation process, will be responsible also for such a broad (re-)pricing of Brazilian assets, regardless of any new downgrading of our credit scores. It is not only our opinion, but also of investors we are constantly in touch with. Public debt is too high, which anyone can see by its increase from just over 50% to 74% of GDP, and rising. Only deep fiscal reform – starting by social security – can public finances be kept on check.

We need to break this inertia once and for all, or else we’ll drive the country to the ground with consequences (no one needs another Greece) similar to the ones seen in Rio de Janeiro and other states in financial distress. Complex problems as a rule do not find simple and immediate solutions, but one must take a first step towards the necessary adjustments.

The voice of the people is right indeed; it is a signal. Political institutions must overcome this challenge of long-term sustainability of public finances, whose major culprit is our social security system.

International Environment

The time is fast approaching to finally prepare to the terms and conditions for Brexit.

For such, PM Theresa May has made more concessions during negotiations with the European Union – EU, in the effort to guarantee alongside other leaders the approval of agreements for the transition period and the very commercial relations with this new scenario. In the face of domestic pressure, May is likely to accept the EU's demands and with it speed up while "ameliorating" the process.

The UK's decision to leave the EU is scheduled to happen in March 2019 and until then various agreements must be concluded, for the Brexit impacts do not befall only on companies and commerce in general, but also it threatens social bonds, as in the case of Ireland. The "success" of an organized Brexit, amid a confusing time for Europe in various aspects, has the power to produce Grexit, Frexit, Pexit… (exit by Greece, France and Portugal…).

In this line of salvation at all costs, financial authorities in the Eurozone are working together to provide Greece (once more) with a plan to guarantee future rescue packages, given the sluggish recovery of the country's economy. Without alternatives and absolutely hostage to its predicament, the Greek government very possibly will have to continue pursuing austerity measures until growth is back on track. Hope dies last, for despite Italy's growth rate has been revised down, the Eurozone's Composed PMI has climbed to 57.5 in November and the Manufacturing PMI registered the second highest level in 60.1 (in most part led by the robust German growth rate!).

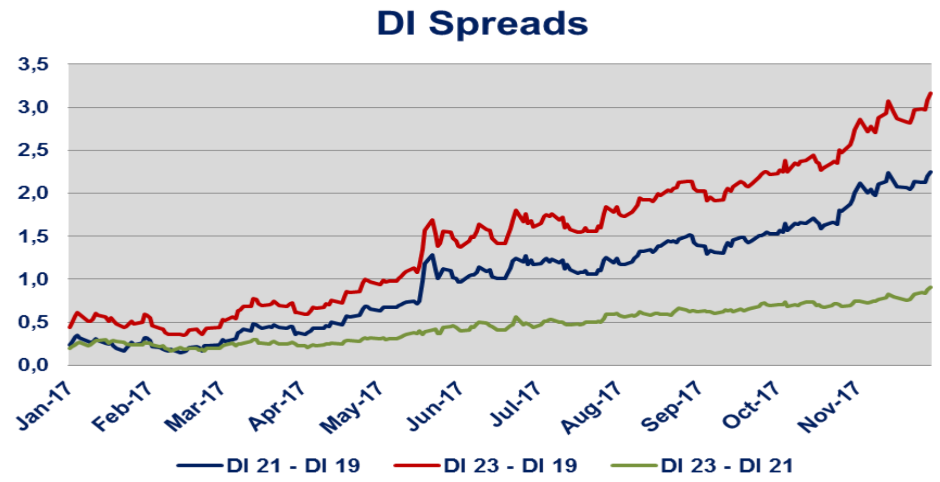
In Asia, after several misunderstanding in the BoJ speech that could very well elevate its interest targets to counter the negative effects of its aggressive monetary policy, its chairman came out to put all speculations to rest, for these understandings led to strong belief that such an action would send out the wrong message to currency markets, which would lead to great risks of a devaluation of the yen, beyond undermining the experiment entailed to reverse the country's inflationary expectations. In China, with President Xi ever stronger, its cooperation project among China, Central Asia and Europe gains strength. The program OBOR – One Belt One Road – aims to invest widely in infrastructure in 68 partner-countries in Africa, Asia, Europe, Oceana and the Middle East. The premise envisioned by Xi and "sold" to allies, invokes the "pacific cooperation, mutual learning, reciprocal advantage and broad integration". The project is indeed ambitious and each one "sells" its "goods" as it best fits oneself – it is legit. However, some Asian countries will not buy this, and the EU itself and the US will soon open their eyes to this expansionist proposal by China. Is there any time left?

In the US, political tensions are on the rise and aim at hindering President Trump's pushing forth his ideas – even the vote of a plan to avoid the Government shutdown (a greater budget deal to keep the administration running), the democrats in the House say they won't vote without safeguards for illegal (child) immigrants. The admission by its former special-advisor Michael Flynn that he lied to the FBI also raises expectations of an impeachment process against Trump. However, all is not lost: the tax reform is about to be approved, an important campaign promise achieved. In fact, Trump is not more of the same… bit by bit he will deliver on his campaign promises.

Interest Rates

The month started off with a decision by the FOMC to keep Fed Funds rate unaltered until the December meeting (in line with our projections that point to one more hike in this last meeting, beyond the other three in 2018). This fact kept international markets calm and prepared the ground for a November marked by a new cycle of dropping interest rates, given the flagrant and complete anchoring of inflation and an ever more substantial signaling of a recovery in economic activity.

However, this was not how it all played out this past month. Greater pessimism regarding the approval of Social Security Reform this year has made investors require greater premiums for the long maturities (once the short have been duly priced), which has reflected in a greater slope for the yield curve. In this line, DI spreads had on November 30th its maximums within the year, as shown in the graph on the side.



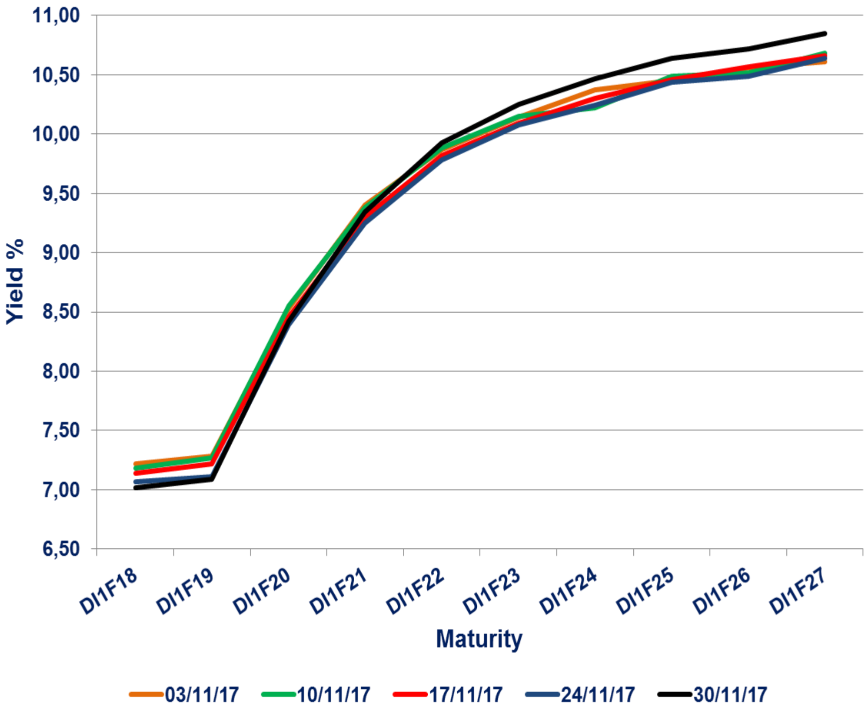
Source: Broadcast and Redwood Projections | Elaborated by Planner Redwood

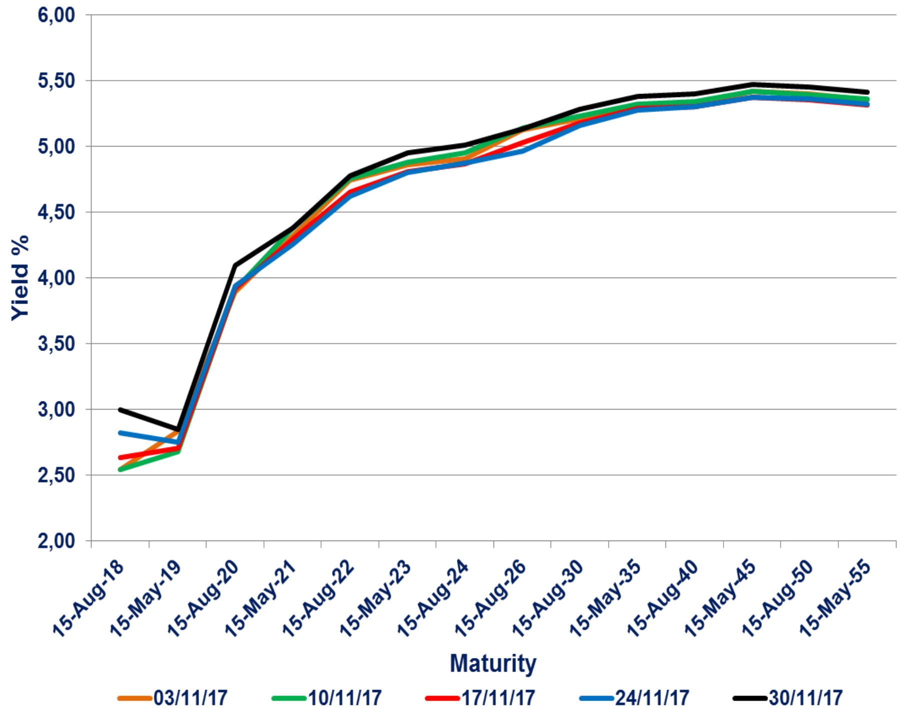
This shows that, as we have highlighted in previous months, the idea of a mismatch between economy and politics lacks foundation, especially when we see fluctuations of asset prices adjust better to reality through time, correcting overreactions. The market, sovereign as it is, has proved us right! However, the same way interest rates have adjusted to pessimism on the social security reform, all one needs is a more consistent signal by Congress so that expectations (and prices!) go back to reflecting the abovementioned downsizing of spreads.

Monetary Policy thus moves on a consistent and sound trajectory in the context that micro and macro indicators point to a more solid footing, above all if the premises and goals of Economic Policy are executed. In the next six months we can have a lower SELIC rate already applied (6.75%) and real interest rate below 3%, but in an environment much healthier than the one seen in 2012/13 – when the inflation spike strongly and consistently forced up the then fictitious 7.25% SELIC.

Interest Rates

Yield and Coupons Weekly Curves (NTN-Bs)

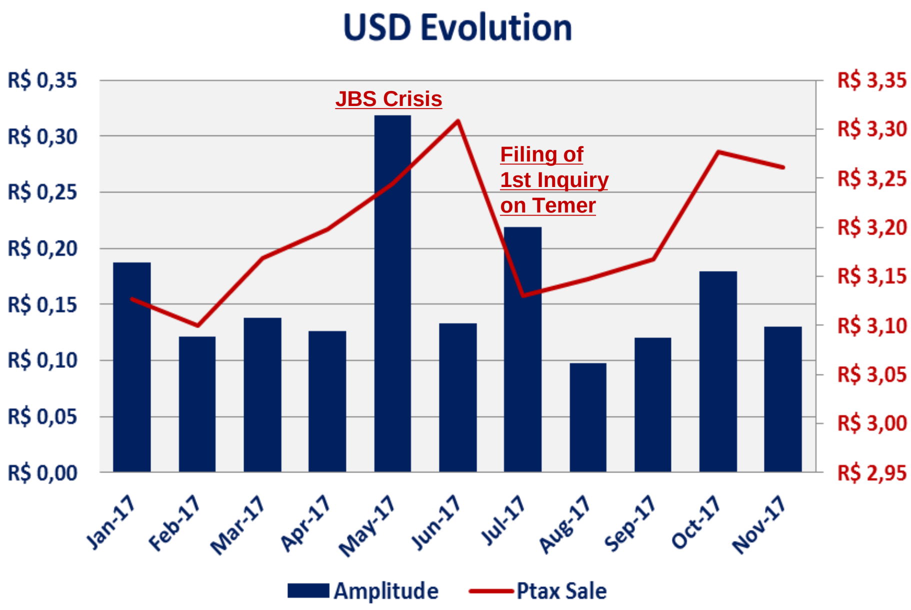




Foreign Exchange

In a month marked by instability regarding agents' expectations as to "the mother of all reforms", we saw the settling of the USD at levels higher than BRL 3.25 (Ptax sale closed the month at 3.2616), a level reached within the previous month and which gained strength with a growing political pessimism. Contributing to such a movement, we had a lower participation of foreign investors in Brazilian markets and the consequent drop in external demand for BRL. In this setting, the exchange rate becomes mostly a reflex of speculative movements tied to uncertainties regarding Brazil's future, especially in what refers to the medium to the long term range.

A month, like the one described above, in which the BACEN did not intervene through trade and rolling over of its swap stock (as it effectively did not) would present, as a widely held view would have it, a strong a unhealthy volatility. The chart to the side speaks for itself. Although the USD has been fixed on a negotiation floor still far from the one originally expected (and which we at Redwood still believe, much closer to levels below BRL 3.10), volatility reached one of its lowest for the year, approaching months in which the scenario raised more positive perspectives and in which, still, suffered intervention by our monetary authorities.



Source: Central Bank of Brazil | Elaborated by Planner Redwood

	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17
Amplitude [1]	R$ 0,187	R$ 0,121	R$ 0,138	R$ 0,126	R$ 0,319	R$ 0,133	R$ 0,219	R$ 0,097	R$ 0,120	R$ 0,179	R$ 0,130
Volatility on Return	0,70%	0,68%	1,02%	0,66%	1,98%	0,66%	0,53%	0,57%	0,52%	0,73%	0,70%
Volatility on Closing Prices	3,70%	2,48%	2,97%	2,45%	7,24%	2,70%	6,65%	2,23%	2,64%	4,90%	2,78%

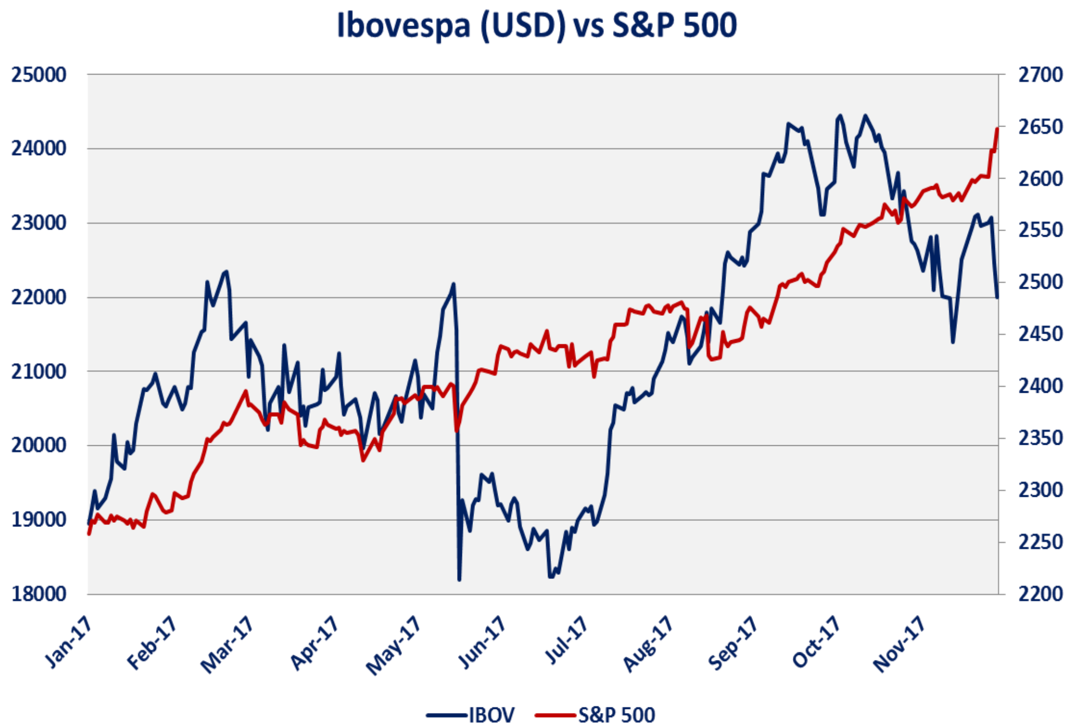
Yet, we know that in December we will have a renovation of the USD 9.6 billion in currency swap contracts, equivalent to 40% of the USD 23.8 billion. Now, we are left with waiting for the December movements which can be marked by a "vertiginous fall" of the exchange rate in the case of a positive scenario, or by the maintenance of current levels should the social security issue be postponed to 2018.

1 – Highest Monthly Value – Lowest Monthly Value

Stock Market

November has marked the end of a cycle of hikes in the Brazilian capital markets initiated in June. Despite keeping a fair level of appreciation throughout the month and bearing overall positive results for companies in the third quarter, it was not possible to shield the Ibovespa from contagion by pessimism as regards the social security issue. Only in the last two trading days of the month the main index in the Brazilian stock markets registered a 3% retraction. A great part of this fall was due to bank-financial sector, a main component to which Ibovespa (in its current theoretical composition) is exposed.

On the other hand, the average daily financial volume has risen to BRL 10.3 billion, the highest for this year, which shows that the capital markets, even under this end-of-month stress, has been rising in investor's preference list. This behavior is couched, mainly, on the highs observed in the previous months that renovated the historical maxims in the Brazilian stock exchange. An important impulse factor in this sense was the Acquisition Public Offering of CPFL Energy, which mobilized by itself BRL 11.3 billion. On the other hand, one must highlight the change we have followed up on in the composition of this growing volume of trades throughout the last months.



Source: Economática | Elaborated by Planner Redwood

Previously responsible for over 50% of trading volume foreign investors had a new drop in its relative share. If in October the number had dropped to around 46%, November registered a new fall to levels close to 41%. It is not about relative composition itself, for foreign investors have in fact withdrawn BRL 3.2 billion from B3 in November. The chart above can, somehow, explain the reactions by foreign investors. In the opposite direction, the share held by institutional investors rose to 29% while households and other types of investors also presented relative growth in their share of trading volumes.

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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