Planner Redwood Asset Management

MONTHLY COMMENTARY

JUNE 2014

Planner Redwood Asset Management

Monthly Commentary / JUNE 2014

Agenda

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

Introduction

We have reached the end of the first half of 2014 and, with this, take a brief stop to evaluate what happened so far and the prospects for the second half of 2014, in financial-economic terms. We also evaluate (for the long-term), the completed 20 years of the Plano Real and its legacy. Incontestably, its main conquest was the end of hyperinflation...for the younger amongst us (say, today less than 30 years old); it is difficult to understand what it is to have a monthly inflation of around 50%, as was the case when the Plano Real was launched in June '94. The chaos in the economy was total and overflowed on to all segments of society. The Plan was not supported by all political parties, but the determination and competence of those who, at the time, were responsible for economic management made the Plano Real go ahead. The stability brought predictability to doing business, the possibility of making plans, realignment and equilibrium of relative prices and, with this, permitted various advances in diverse segments of society: the labor market formalized and social inequality decreased. The Plano Real put Brazil on a new level of development: but that was the first step…it is now time to take the second, because the country needs structural reforms: labor, fiscal and political. But wait! Before taking the next step we need to ensure that the first is on firm ground and solidly placed! Over the last years we have abused the conquest, and the first six months of 2014 ratify this. Let us readjust in order not to go backwards!

If here in Brazil what worries us is inflation, in other parts in the world, such as the USA and (more to the point) Europe, the specter of deflation is what causes a headache. More specifically, in the EURO Zone, for the 18 countries that share the Euro, the rate of annual inflation remained at 0.5% for the second consecutive month. It was the ninth consecutive month in which inflation remained within, what the President of the CBE, Mario Draghi, called the "danger zone": below 1%. Surreal? Well, there you are, such is economics...everyone with their own problems. However, in the globalized world in which we live, "their" problems can be our problems (but not necessarily vice-versa).

In addition, we are in the middle of the World Cup which, if does not in fact resolve problems, at least relieves tensions and brings fun and happiness to many people...yes, even the USA, which always turned their noses up at the most popular sport in the world, seems to have succumbed to this passion and are playing good games: A lighter world, at least momentarily.

Confirmation of a much weaker US GDP due to the extreme cold and thoughts on this year (we continue optimistic) reflected on the US Treasuries, which closed the month at 2.52%. S&P changed 1.91%, NIKKEI closed at 3.62%, DAX at -1.11% and the FTSE at -1.60%. In Brazil, the Ibovespa ended the month at 3.76% and the IBrX at 3.62%. The high for the DIF15 was 10.85% and the DIF17 11.77%. NTN-B 2050 ended the month at 6.16% and the Dollar at BRL 2.2025.

Economic Activity

With the end of the first six months of the year, there is unanimity in relation to economic activity amongst the various entities that follow and signal their perceptions of it: all adjusted their forecasts downwards. The Government, with its official target going from more than 3% to something still above 2%; BACEN with a reduction to around 1.6%; the financial market to 1.1% and us, Redwood, in our review of the first half of 2014, retreat from our projection made at the end of 2013 of 1.64% to approximately 1% (0.97%). If calculating these previsions is never an easy task, recognition of the evidence eases our understanding and acceptance of the facts. High inventories for car manufacturers, surplus increase in capacity, lack of confidence and postponement of investment decisions by entrepreneurs, etc., seem to indicate we are expanding the output gap.

Naivety is not a characteristic of this Government, and all those involved already see with absolute clarity (so we believe). Therefore, if the reality is so clear, why is there no change in attitude? I always remember the perplexity with which Albert Einstein sought to understand why humans always repeat their actions, but expect a different outcome (if even he could not understand?!)... Maybe because of a combination of factors: ideology (the macroeconomic matrix will one day function), the “inefficient” markets will eventually adjust; the economy goes through cycles that we unavoidably have to weather; the Government has to make its presence felt more to help the economy and/or “stronger” measures for the economy could prejudice the political moment. Whatever is the reason, what seems to prevail is the maxim “kick the can down the road” until the elections in October...in other words, leave it as it is and we will see what happens, for the assumption is that nothing done at this time will change history for this year (short-term). And so it goes, with a patch here and there, praying no extraordinary event occurs and counting on international economics having a low impact.

Backstage is a tug of war between the Government and BACEN (Fiscal and Monetary Policy – who “hinders” the most). It resembles the quandary of the “Prisoner’s Dilemma” (seeing as the two do not “speak”), the most known example of the Games Theory proposed by Albert W. Tucker in 1950. The situation is the following: two thieves are accused of the same crime. Held apart from one another, the sheriff gives each the choice between confessing and denying the charge. If neither confesses they will only serve 1 year each. If both confess, they both get a 5 year sentence. If one confesses and the other denies, the first will be set free and the other will serve a 10 year sentence. In this case, for someone who is in fact innocent and will suffer (the Brazilian society), how many years will Brazil serve? It is the prison of stagflation!

Fiscal Policy

Tighten your seatbelts, the pilot vanished!

Every month, we emphasize on this space the fundamental importance of the Fiscal Policy for the economy and how neglectfully and disdainfully it has been treated. There are innumerable contortions and creative accounts made to produce figures in line with those promised, but the numbers have given no respite. However, the result of public accounts have been disappointing in recent months, May was a disaster! The Treasury released dismal Revenue figures and the Central Bank announced that, in the period from January to May 2014, we had the highest accumulated fiscal gap of the last 12 years!

To make a long story short, the numbers summarize as follows: May's primary deficit reached BRL 10.5b – the result includes the accounts of the Treasury, INSS and Central Bank. For the year's result as of May, the accumulated surplus came to BRL 19.16b, equivalent to 0.93% of GDP. The drop is 42.4% in relation to the same period of last year, when we had, by this time, a surplus of BRL 33.27b. This performance reflects a growth in expenses above revenue: expenses increased 11.1% and revenue only 8%.

May is not, historically, a month of great results. However, not even the market, with its huge range of forecasts (the expected range was between a deficit of BRL 6.5 and a surplus of BRL 4b) expected this figure.

Therefore, it is almost impossible to reach the target of 1.9% of GDP (already adjusted from the original 2.1% GDP), due to Revenue decreasing from to the piffling growth in GDP; current proceeds from dividend paying state enterprises being substantially lower; the Federal Revenue (Refis) and a lower bonus from public service concessions. In addition, we glimpse no sign of the Government changing its trajectory…on the contrary, by continuing to give benefits (to chosen sectors) based on tax exemptions and by increasing its expenses, it foments a deterioration of fiscal results. OK, so what? So, our gross debt continues to increase; one of the main indicators used by the Risk Classification Agencies that could (with this) pull back our Rating (lose our Investment Grade). All that is needed is for a new evaluation to point out the negative prospects and the fall-out will be enormous.

The pilot needs to come back and re-take control.

International Environment

The contraction of the American economy was even greater than expected: 2.9%. This fact fostered the perception of the more dovish discussion team, which became even more intense. Our view is that it is an uncontroversial fact and important, but absolutely punctual and non-recurring for this year. So, only this situation and atypical characteristic of the US economic activity in the first quarter are the justification of the position taken by the President of the FED (American Central Bank) for giving signs that the institution will do nothing, even when it finishes tapering (reducing the volume of its purchases of assets)...it is the DNA of the Harvard team...no surprises. Now, it is also incontrovertible that the FED wants to have a transparent posture and one of communicating its actions clearly – including its premises, expectations, limits and definitions. Therefore, with the second half of the year giving signs of improvement in employment, more robust PMIs (Purchasing Managers Index), desired inflation, warming markets and increased activity, a more inert FED will be difficult...the meeting in September will divide the waters and indicate the direction of the American economic policy and, with this, its impact on the world and, consequently, on our economy and finances.

In addition to the improved data on manufacturing activity in the USA (PMI according to Markit increased to 57.3 in June, against 56.4 in May – the highest level since May 2010), in China, the official industrial PMI rose to 51.0, indicating an expansion since December. In Europe, particularly in the Euro Zone, some PMIs disappointed. The block's industrial PMI dropped to 51.8 in June, from 52.2 in May, remaining below the preliminary calculation of 51.9. The equivalent indexes for Germany, France and Italy were also weak, but the manufacturing sector in Spain and the United Kingdom showed greater strength. Still in the Euro Zone, when evaluating unemployment the quagmire remains extensive... despite the number of unemployed having dropped by 28 thousand in May this year compared to April and 636 thousand compared to May 2013, 18.55 million remain unemployed – 11.6% according to data from Eurostat. In the period before the crisis of 2008, this number was 11.5 million.

In Japan, the PMI of the industrial sector returned to an expansion level this month. According to final numbers of the data suppliers Markit and Nomura/JMMA, the index climbed to 51.5 in June, from 49.4 in May.

In the political and social camps the international scenario does not seem to have changed significantly, nor is there a new important situation developing in the near future, at least not one having a major global impact or with economic consequences. Amen. The current political-economic and social problems are already sufficiently "radioactive".

Interest Rates

The semester was for Fixed Income Investments!

Investment in less volatile assets produced greater real yields than simply investing on passive Bovespa indexes. The CDI ended first semester '14 with a nominal yield of 4.97%, while inflation-linked bonds consolidated in the IMA-B index accumulated yields of 5.63% in the year (with the inflation of 3.68% in the period discounted), despite the fact that in June NTN-B's from 2020 maturity closed on the negative side.

The rates for futures interest followed the FX and Treasury rates. Inflation indexes published in the month showed a deceleration (seasonally typical), mainly for non-manufactured products, and data on activity continued to indicate a slow economic rhythm. With this, the futures interest rate curve indicates there are a minority in the market that bet on a cut in rates during the last month of the year, despite the paltry fiscal results and the difficulty in reaching the target of 1.90% of GDP. Over the month, there were alterations in the slope of the curve, with short-term interest rates decreasing in yield and long-term ones increasing. The graphs below illustrate this.

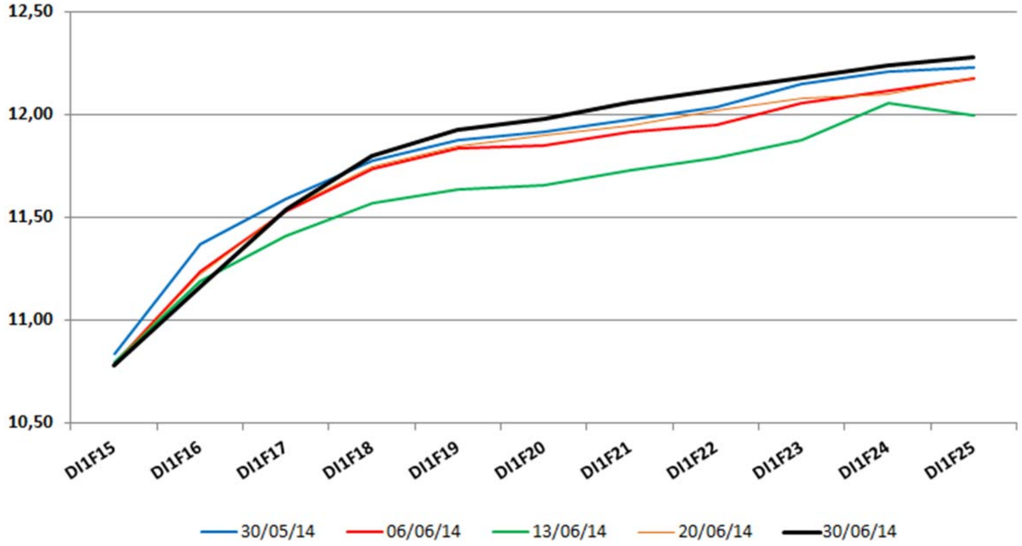
In our view, the Monetary Policy during second semester '14 will take an absolutely neutral position and the monetary authority will simply move with the events as they unfold (except in case of an extraordinary event), supervising and eventually putting into practice punctual measures…no increasing interest rates until the end of the elections – no matter what happens.

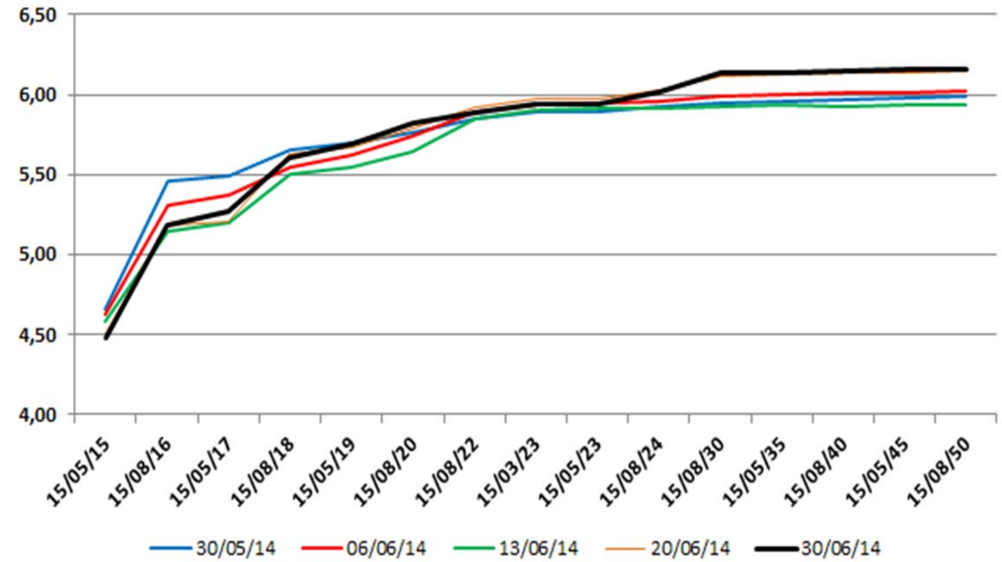
Corroborating the above are the recent statements made by the President of BACEN, Alexandre Tombini, who asserts that, to combat the pressure on prices, the monetary conditions were tightened, but the effects of the increase in the Selic rate on inflation are, "in part", still to materialize. He also mentions the theme of realignment of relative prices, as a realignment of managed and free prices would already be on course…how so??? The President of BACEN also analyzes the foreign picture and concludes "the international scenario seems not to have changed much, only recovering somewhat slower than anticipated a short while ago"… enough to evoke the Keynesian expression of "animal spirit", that even the monetary incentives used in the last years, especially in the United States that avoided a "new Great Depression", were not able to improve, in a "permanent and significant" way, the confidence of the real sectors in advanced economies. After all, during crisis we are all Keynesians, right?

We expect nothing different than described…our spirit cannot remain, shall we say, animalistic.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

The American currency started the year under pressure, but ended the semester at BRL 2.2025.

Projections of the Dollar at BRL 2.40 by the end of the year were already gaining strength by January. However, Government intervention in the foreign exchange market via swap auction programs (equivalent to the sale of currency on the futures market); the increased Brazilian interest rate; the movement of Treasuries and the return of a foreign flow to the country, had the American currency end the semester with an accumulate drop of 5.98% (PTAX BACEN)

Despite the interventions in the market since August 2013, the uncertainty during the start of the month as to the roll-over of the swap contracts and the expectation in relation to BACEN's intervention program, stressed the FX market. The Dollar reached a six month high against the Real. The Government's decision to reduce from 360 days to 180 days the average minimum maturity of external funding that will incur no foreign transaction tax (IOF) did not influence the market as expected. But a confirmation by BACEN that it will continue its swap program and the decision of the FED to keep interest rates unchanged and reduce incentives by US$ 10b held back the upward trend of the FX market.

Our scenario remains unaltered, but a light starts flashing when we evaluate the increased deficit of the current account, which indicates that the real FX rate could be appreciated…and the most common way for this distortion to be corrected is via the nominal exchange rate. In any case, the BACEN seems to be "comfortable" with the current foreign exchange rate.

The "comfort" with the present foreign exchange rate is directly related to inflation, obviously. However, containing inflation via an exchange rate (as a) anchor may not be a good idea…it undermines competitiveness and creates innumerable distortions. But, in view of the mistakes made and the "impossibility" of other actions, is there any other mechanism available?

Stock Market

It took time...since 2009 the Ibovespa had not closed the first semester with positive returns. As of the end of the first semester, Ibovespa accumulated a gain of 3.22%. It was a semester marked by two, very distinct, movements: up to 03/14/2014, the Ibovespa devalued 12.70%, from that day, the downward trend reversed and the index accumulated gains of 18.24%. The movement in the equities market reversed with the onset of polls for the President of the Republic indicating that the electorate is not satisfied with the current government. It was a volatile semester and, as mentioned in previous reports, the movement occurred more as a function of the flow of resources and a possible change in the management of the country (with a direct impact on the life of companies) than due to a change in fundamentals: A difficult situation in which to manage the short and medium term.

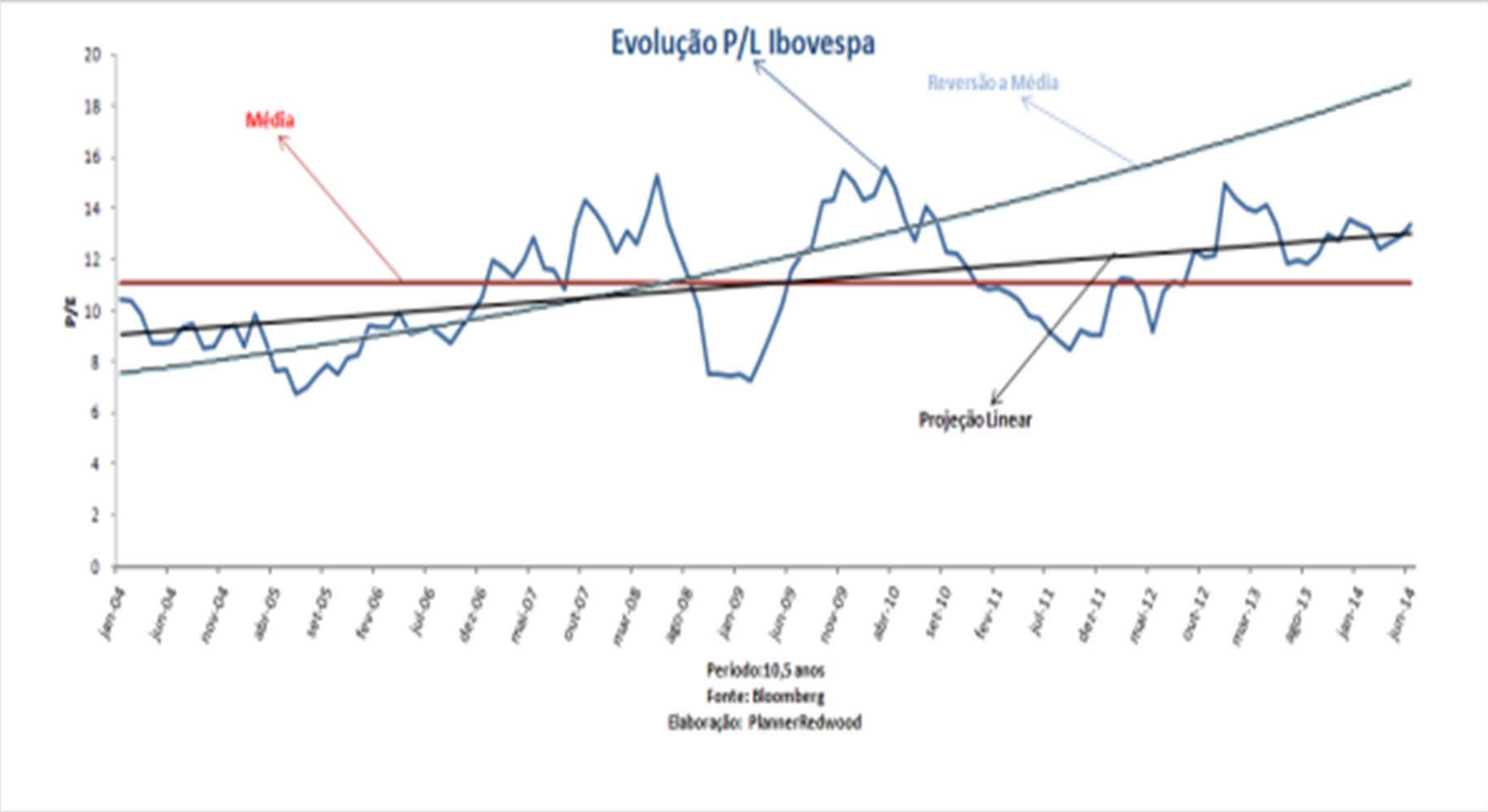
June started with a strong valorization of the Ibovespa, with election polls showing a decline in intent to vote for President Dilma and a reduction in the lead between the government and candidates of the opposition in simulations of the 2nd round. The Ibovespa ended June up 3.77%.

During the month we saw various institutions revising the scenario of Brazilian and global economic growth, after publication of the first quarter GDP in Brazil and the USA. The numbers disappointed, but we continue firm on our quarterly projections and revisions! Industry is the villain of Brazilian low growth. Scenarios of weaker activity weighed heavily on the stock market, causing it to give back part of the gains it made at the start of the month. During the World Cup, which could have improved aggregate demand, we expect a certain retreat in relation to that expected for business and trade on the Stock Market due to the various vacations given with the games. Added to lower trading on the Bovespa are the vacations of the northern hemisphere and, obviously, the uncertainties as to the political scenario. Incentive packages for the economy, such as the extension of the PSI (Investment Support Program) to the end of 2015, reduction of the first payment of Refis (Fiscal Recovery Program) and extension of the reduction in IPI (Tax on Industrial Products) did not have the expected impact on the financial market.

Of the shares, we highlight state owned companies which, in the same way as last month, went up when polls indicated a deterioration of intent to vote for the government. A relevant fact in relation to Petrobras was the government's selection of the company to explore four oil fields, without a competitive bidding (auction, with payment by the company of a BRL 2b bonus on signing the contract. News interpreted as negative due, in part, to the difficult cash position of the company and possible reinforcement of public accounts ("manufacturing" extraordinary revenue). Shares of banks dropped due to bad debt. The graph below demonstrates the present situation, using the important Price/Earnings (PE) index of the Ibovespa.

Stock Market

Ibovespa P/E Graph



Monthly Commentary

JUNE 2014

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