Planner Redwood Asset Management

MONTHLY COMMENTARY

MAY 2017

Monthly Commentary / MAY 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.

"In the face of triumphant nullities, of prospering dishonor, of growing injustice, of swollen power in the hands of evil, a man is bound to grow weary of virtue, to laugh at honor, and to feel ashamed to be honest".

Rui Barbosa – Former Brazilian politician, diplomat, counselor and lawyer.

Introduction

Brazil sends out an S.O.S. to the world!

On May 17th 2017, at 7:30pm, a new scandal struck the country. This time it involved President Temer and had massive scale. So large a scheme, whistleblowers claim that no less than 1.829 politicians are implicated in this episode.

It is unparalleled and, to the extent that true statements can be found, it looms as one of the greatest corruption scandals in the history of not only Brazil, but of the world. Its range is overwhelmingly wide, for it drags to the same ditch "leaders and acolytes" of all tribes, at all levels of the administration. It is endemic to this point.

In this sense, the "cleaning process" the country finds itself mired in no longer carries any suspicion of bias, something claimed by a few up to recently (especially by PT). For better or worse, this claim is no longer valid.

What matters, however, is that this crusade against corruption has a "pace" of its own – a "pace" which, under current circumstances, becomes exceedingly dire to the country. Brazil faces a set of problems, under relations of causality or not, that are reflexively aggravated by political-institutional crises. Every instant-sign of recovery of some economic order – such as improving confidence, inflation, economic team in line, etc. – is quickly followed by some new and surprising crisis. But Rui Barbosa has previously posited the essence of such a reality, as quoted in the epigraph of this commentary: "*In the face of triumphant nullities, of prospering dishonor, of growing injustice, of swollen power in the hands of evil, a man is bound to grow weary of virtue, to laugh at honor, and to feel ashamed to be honest".* It shall not be such an extraneous hurdle we won't be able to overcome.

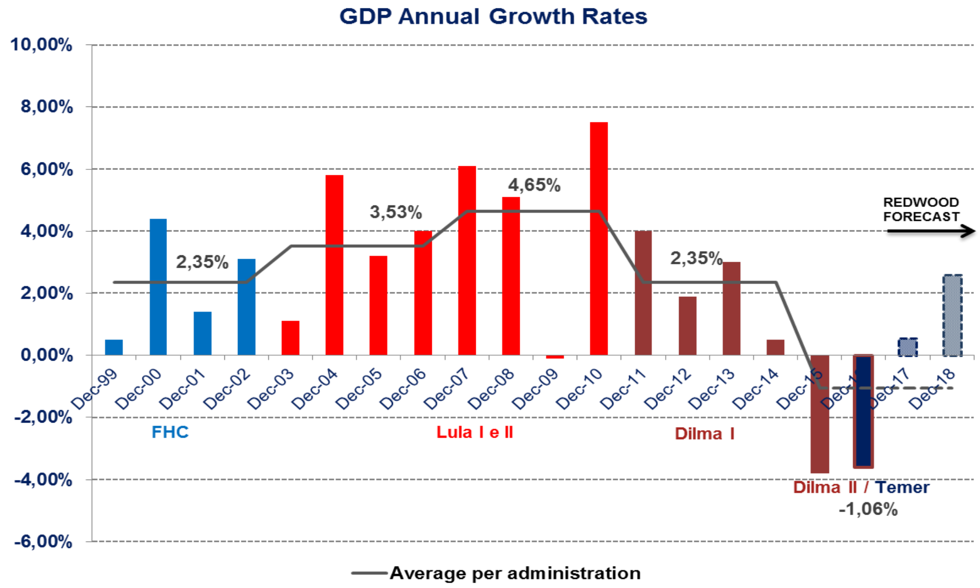
Worldwide, we have had a little of everything. France and its new president Emmanuel Macron, Theresa May prepping up for elections and the rest of Europe facing its everlasting economic issues and the new and preferred inclination to oppose the new reality, as presented by Donald Trump. In this line, China and fair part of Asia join the chorus, as expected, given the last move by the American president to withdraw from the Paris climate agreement. In his turn, Donald Trump "seizes" the atrocities perpetrated by terrorists to make his word heard and implement campaign promises – seems fair, especially for the majority of his constituents.

In this landscape, the US Treasuries closed the month at 2.2028%. S&P varied 1.16%, NIKKEI closed at 2.36%, DAX at 1.42% and FTSE 0.59%. Ibovespa finished the month at -4.12% and the IBrX at -3.66%. Highs of DIF18 at 10.08% and DIF21 at 11.49%. NTN-B 2050 ended the month at 5.59%, and the Dollar (Ptax) at BRL 3.2437.

Economic Activity

The Brazilian Institute of Geography and Statistics (IBGE) has released the results of Quarterly National Accounts and with them the "good" news of a 1% increase of GDP in the first quarter of 2017, against the previous quarter. It is the first high after eight quarters of slowdown. A relief – no doubt – which caught many economists and market expectations off guard.

However, it is not time to celebrate yet. It seems premature to extol optimism, as have both the President and the Finance Minister positioned themselves. Is recession over? We wish, but nothing warrants such audacity in stating so. We need a few more quarters with good figures and a healthier environment to confirm such omens.



Source: IBGE and Forecast Redwood | Elaboration: Planner Redwood

Some data mentioned in the previous report have now been confirmed: imports and exports have grown and the statistical effect in certain sectors, such as manufacturing, seems to have prevailed in the rate claimed. Moreover, what is most frustrating of all numbers is the Gross Formation of Fixed Capital (GFFC) completing 12 quarters of falls! This indeed, the great indicator, the so-called Investment Rate, is now around 15.6% as share of GDP (GFFC/GDP). This rate shows how much we will grow in the future – we are close to 10 percentage points below the desired rate, miles away from other emerging markets. At any rate, a journey starts with the first step… hence the graph displaying our perspectives for 2017 and 2018, and a summary below that situates us currently according to the data released by IBGE:

Period	Manuf	Agric (*)	Serv	GFFC	Export	Import	Household Cons	Govt. Cons.	GDP
1o QTR 17/4o QTR 16	0.90%	13.40%	0.00%	-1.60%	4.80%	1.80%	-0.10%	-0.60%	1.00%
1o QTR 17/1o QTR 16	-1.10%	15.20%	-1.70%	-3.70%	1.90%	9.80%	-1.90%	-1.30%	-0.40%

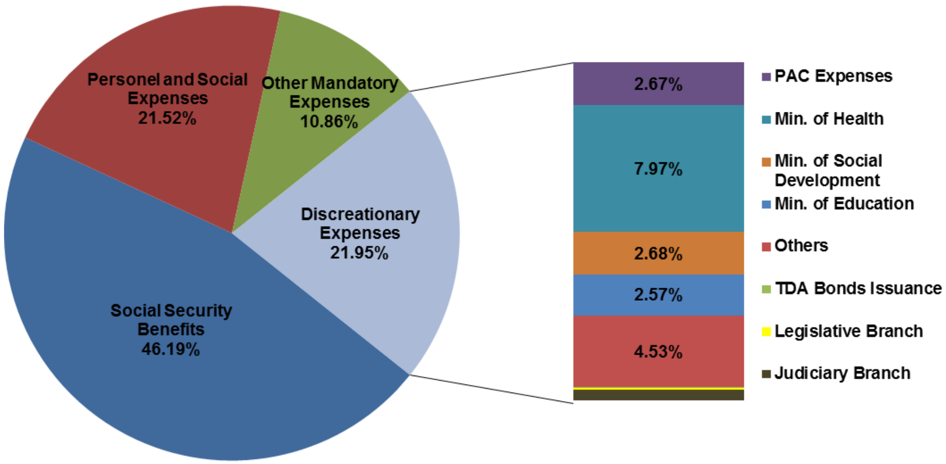
(*) Exuberant performance – no surprise… the eternal "Savior".

Fiscal Policy

If the formula arranged for the Public Finances, corrected for one-year-lagged inflation, is not exactly the most adequate to our eyes, at least one can acknowledge the important component inserted by the BNDES. Under the command of the now resigned Maria Silvia, the BNDES has promoted (i) the lowering of earmarked credit with lower subsidies conceded since the end of the PSI and (ii) the reduction of TJLP–SELIC differential – translated by the new long-term rate (TLP). They are, in the limit, contractionary measures – although they fall short of what we need. At any rate, according to the Finance Minister, we are under a contractionary fiscal adjustment with a negative fiscal impulse of a 0.5% magnitude.

However, the graph on the side displays the composition of primary expenses and leaves no doubt as to the narrow space for more significant cuts, within the patterns set by the current administration to date. From this angle and with the approval of the Expenditures Cap, we underscore the centrality of Reforms, above all Social Security. We count on these Reforms to spare some funds, so that no other sectors fall short of budget resources.

Composition of Primary Expenditures – 12 month accumulated



Source: National Treasure | Elaboration: Planner Redwood

But unfortunately the political crisis has taken center stage and all else is conditioned by its resolution or rearrangement. Beyond these absolutely unpopular measures and a far from persuasive propaganda campaign, opinion makers and various congresspersons do not see the Reforms as a prerogative of the State, but a measure by the Government.

In the face of such an impasse, we are at the mercy of debates with expectations that this constitutional amendment be passed by August, but in order for that to happen, discussions on the matter must begin in the first half of the year. Will they? However, responsibly speaking, which would be the Plan B in case political instability halts approval in the House? It seems unlikely that the economic team has not mapped out an alternative.

If there isn't in fact a Plan B, we hammer down the same idea: review and if possible end the far fetched tax reliefs by Dilma and Mantega – estimates support there are over BRL 260 billion in tax relief and expenditures to be revised. Other measures such as the revision of current expenses to contracts with civil persons and the suspension of wage increases to public servants should be in the fore. Better this than the vulnerability of sudden ideas of an imprudent bystander.

International Environment

France has finally chosen a president less inclined towards the left – Emmanuel Macron. It is interesting that he has won the elections with a certain advantage, but faced enormous opposition the day after the election. How so? Simple, he was elected so that the ultra-right candidate Marine Le Pen would not rise to office. Anticipation for the UK elections has brought great headache to Theresa May, especially with the return of terrorist attacks – thus jeopardizing her party and her position on the cuts on the public safety budget. Anyway, it is beyond any doubt that there has been improvement in the political landscape of the Eurozone, given elections taking place in France, Netherlands, and Austria. This reinforces our perception – as stated by the German Finance Minister Wolfgang Schäuble -, that it is about time the ECB changed his take on monetary policy… but inflation more fragile in the Eurozone renders this possibility less likely to hold. In other words, it may well be that the highly expected monetary tapering won't happen any time soon – in line with Mario Draghi's stance.

In China, latest news point to a slower GDP growth (figures for manufacturing, fixed asset investments and retail), but this is unlikely to change the PBoC's monetary policy stand. On the other hand, Japan faces moves by its BoJ's Committee members to defend aggressive monetary stimulus – to be confirmed in July. India, in its turn, is the preferred country among emerging markets nowadays, and takes seriously its nonperforming loans problem, which may translate as excellent news for private banks – with further positive effects for the country.

In US the only tune the band play is: Russia, Russia, Russia. The mainstream media won't stop talking about the alleged Russian interference in Donald Trump's election last year. Russian President Putin has peremptorily denied any involvement, although admitted the possibility that some "patriotic hackers" may have acted in this sense, in retaliation to the state of relations between the West and their country. Besides that, he classified as a "Russiaphobic hysteria" that which is taking place in the US with the objective of "impeding the American president, Donald Trump, from doing his job".

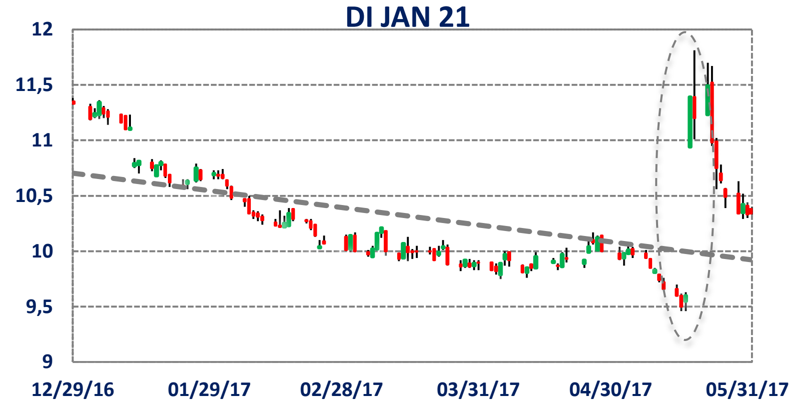
It seems undoubted that the FED will raise interest rates twice this year, first by next meeting in June/17, notably after the release of Private Sector Employment Report. The study indicated 253 thousand jobs were created in May, exceeding analysts' forecasts. In truth, the US economy seems highly reasonable (GDP growth above 2% and close to full employment), FED's targets on line and risks well balanced – being the recent fragilities absolutely transient. Expansionary fiscal policy promised by Trump and its effects loom as a threat, particularly in the face of innumerous uncertainties that involve the matter. For all these reasons, there is some room for the FED to shrink its balance sheet.

After all, someone is going very well in the planet.

Interest Rates

A period of calm and good winds was set in the horizon also in the interest rates practiced (both nominal and real), until once more the country was flooded by this quagmire of corruption – curbing the positive economic landscape that gained momentum… the financial markets, obviously, did not let it fly.

The scandal was made public soon after markets closed. In the following morning, effects were immediate: many operating houses were forced to realize the stop loss of their interest positions, as well as in exchange rates and stocks. Asset price deterioration was swift and intense, as displayed by the graph below. Derivatives contracts due in January 2021 (DIJAN21) soared from 9.5% yearly to 11.5% yearly rates. The same took hold with other maturity dates along the yield curve. The trend line of interest fall was abandoned – at least, for now.



Source: Broadcast | Elaboration: Planner Redwood

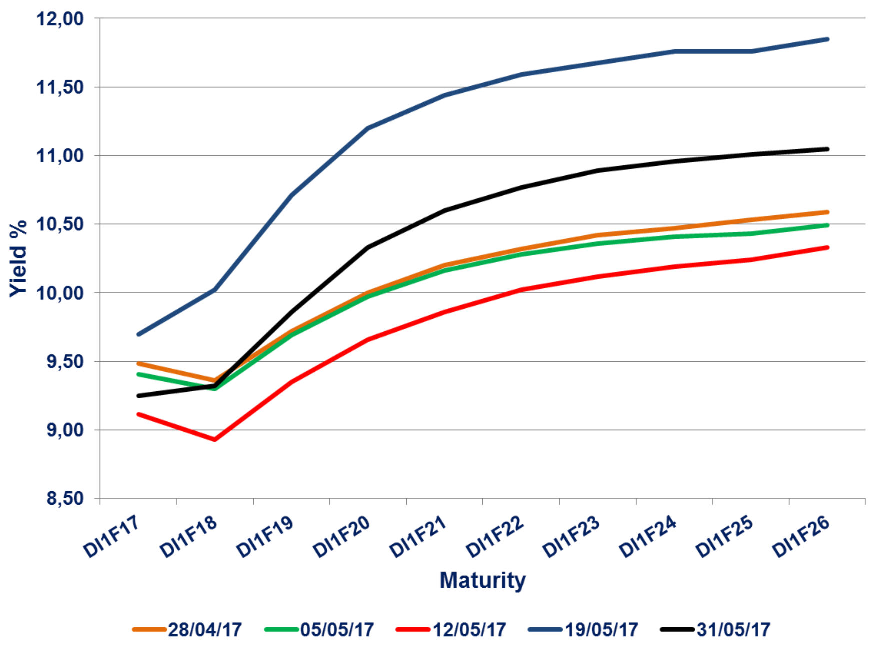
Until that fateful Wednesday, May 17th 2017, many players in the market believed the COPOM would be more hawkish and increase the pace of interest rate cuts to 125 b.p. (we at Redwood have always maintained our projections of a 100-b.p. pace) couched on the positive expectation for inflation scores. However, the winds and expectations changed and the Committee chose caution and kept the pace of cuts at 100 b.p. and still added that the pace of cuts is bound to slow down in the next meeting. Score one for the BACEN's team; the measure was correct, for it does not fall in the way of medium- and long-term plans of monetary policy, whilst signals absolute "understanding" of the gravity of the situation and its consequences for economic policy as a whole.

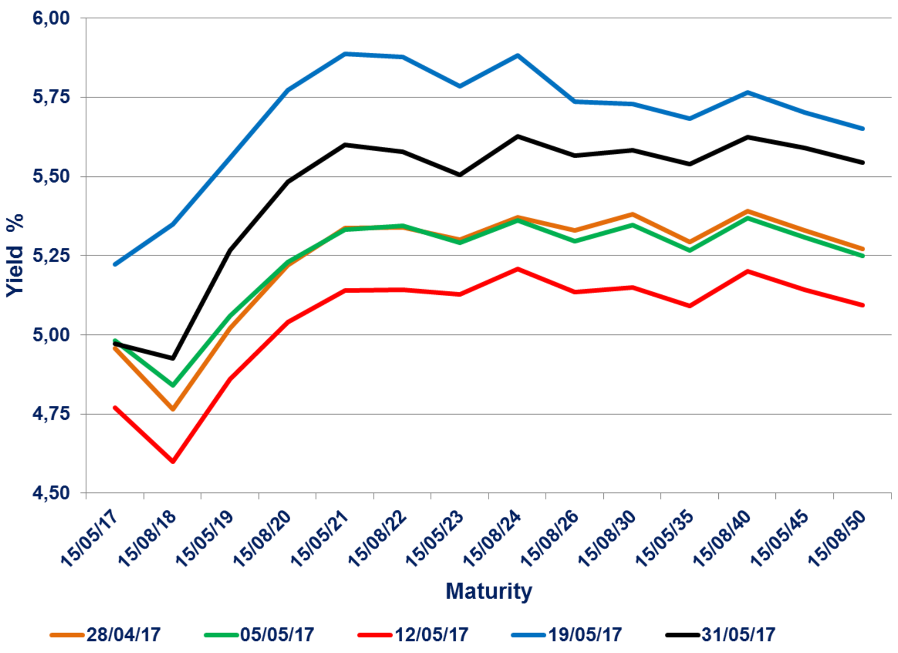
The country has endured, yet again, a period of political uncertainty – or, to be more blunt, we have gone on Political Dominance mode. If the crisis does not lose force and uncertainties are not trimmed, interest rates won't fall as fast as it is possible and desirable in an environment of plunging inflation and weak activity on the real side. What a mess, JBS!

This time rating agencies were quick – to be true, too much so. S&P has placed Brazil's sovereign credit under negative oversight (CreditWatch) which is a short-term alert that risk assessment reflects the rise in uncertainty. Moody's has changed the perspective of sovereign credit for Brazil from stable to negative, keeping the country's grade at Ba2. The haste of agencies here does not seem to be justified… the situation is of course worrisome, but Brazilian institutions have worked well and, furthermore, the financial market usually overreacts to crises (especially in the short run). CDS (main solvency indicator to the country, and a type of compass for rating agencies) stoked from 200 to 268 points the next day, but is back at 240 points. To a certain extent interest rates have too. We'd better assess it with great temperance.

Interest Rates

Yield and Coupons Curves (NTN-Bs)





Foreign Exchange

The sky in the beginning of the month seemed friendly; all went well. Favorable scenario and soaring optimism by investors, both foreign and domestic, the Dollar reached BRL 3.10… and all pointed to a greater devaluation. We are currently amid a reevaluation stop. Once again, skies turn grey.

Up to the deployment of the new political scandal, the Dollar oscillated in response to commodities prices, in the expectation of only two more interest rate hikes by the FED, as reflex of French elections and above all due to intrinsic evaluation of Brazilian politics and economy. Dollar quotes at BRL 3.10 in the first fortnight was an important resistance point if overcome and would roll back to BRL 3.05 moving further down to BRL 3.00 – where, by our models and assessments, it is likely to settle. Apart from typical market fluctuations, the Central Bank's rollover of the currency swaps stock maturing in June also contributed to the appreciation of the BRL… jeez, thank God for the BACEN and its exchange rate policy!... if not, let's see: the May 17 tsunami "altered expectations", at least in the short run, regarding the BRL appreciation. The American currency soared, rising 8.07% in one day and closed at BRL 3.38. It was the third greatest percentage hike in history, after only two episodes registered in the maxi-devaluation of 1999, when Brazil abandoned the exchange-rate range policy. Exceptionally, B3 has expanded the trading limits for future contracts for currencies from current 6% to 9% over prior adjustment. The Central Bank and the National Treasury have intervened strongly in the market with extra auctions of currency swaps and also of purchase and sales of securities. The Central Bank's action was not localized, keeping active in the market in the following days… of course, necessary positioning and in line with its mindset so the market would not drift away. Apart from the (true) report and certain sarcasm (yet more genuine!), the Dollar has closed the month at BRL 3.24… and, by the looks of it, must work at this level, until the closing of the political crisis… independently of new interferences by the BACEN – which does not control volatility nor quotes!

For the month of June the Central Bank has not released how its rollovers will play out. Rumor has it that the Central Bank will take a stand only after June 6th, when the trial of the Campaign of Dilma and Temer will begin at the Supreme Electoral Courts (TSE). Who knows?... so is the exchange rate policy.

News in currency markets was the opening by the Central Bank of a new channel of communication with the Brazilian currency markets. The Consulting Committee of the Currency Markets will comprise representatives of the institution and of 26 players – among banks, trading houses, investment funds and companies with strong stake in the sector – and will serve as a forum for the discussion on the functioning of the market. Among this committee's prerogatives, according to the monetary policy director of the BACEN, is the application in Brazil of the FX Global Code, which gathers principles of good practices to be adopted by countries. The intention is to turn currency markets more liquid, robust and transparent – defining principles and a set of guidelines for governance, ethics, information sharing, execution, risk management and compliance, and confirmation and settlements processes. The proposal presented by the BIS (Bank for International Settlements http://www.bis.org/mktc/fxwg/gc_may16.pdf) carries good intentions, but the adoption of it notably by countries with an interventionist bias in currency markets is a nice "excuse" to attend to other ends and justifications.

Does the hat fit our heads?

Stock Market

May was the worst month for the Ibovespa!

The troubled political scenario at home, the data falling short of expectations regarding China's foreign trade and oil price volatility influenced returns in the Stock Market in the month. In the aftermath of the release of the recordings featuring the JBS executive and president Temer, the Ibovespa closed with a 8.80% plunge, forcing B3 to trigger the circuit breaker at the outset of negotiations to contain volatility. However, part of the fall was reversed throughout the month with the inflow of foreign investors detecting investment opportunities after the drop in asset prices. The Ibovespa closed the month at 4.12%.

The Brazilian economy, including its real side, gave its first signs of recovery, albeit timidly. Public companies' first quarter balance sheets informed improving revenues and lower expenses with debt servicing, in the face of accelerated fall of the interest rate SELIC. However localized, companies have displayed growth in volumes and stronger cash flow. Prices already reflected a slow recovery, but not the possible return to stagnation or recession (they still don't). Nonetheless, in the face of the magnitude and potential protraction of the crisis, investments are likely to be postponed. Credit lines to companies and the short-term working capital lines of big banks continue to shrink. A rise is only seen for delinquency, especially the short-run ones.

Stock market investors are showing perceptions more swiftly, under the strains of doubt concerning the continuity or not of President Temer, of his economic team and especially of the structural reforms, essential to restore growth. Thus while no definition is posed on this, a previously fading recession now looms over Brazil and by consequence haunts companies' performance in stock markets. In truth, the crisis is not the worst thing in itself, but the uncertainty that it raises. Amid the Political Dominance we were thrown into, everything points out to our country bleeding more for some time. This situation promotes two alternatives for players of such markets: (i) short-term opportunities and/or (ii) opportunity for those who can identify assets with greater value and which are extremely discounted and which can afford the long run, associated to total insensitivity to volatility.

Any other alternative, in this moment, does not seem to be a good idea.

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