Planner Redwood Asset Management

MONTHLY COMMENTARY

JANUARY 2014

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Introduction

If 2013 was a difficult year, 2014 already revealed its character in the first month. Nothing that should frightens us too much, because forecasts made since the end of last year did not indicate a benign perspective and, therefore, things progress very much as we had in mind...mostly. In fact, if we are right about the direction things are going, the rhythm is more intense, and comes from various directions.

January was a veritable nightmare for emerging markets: investor confidence vanished. Fiscal deficits, China's economic slowdown, the increased risk reflected in interest rates, the reduced attraction of the stock market, corroborated by the change in monetary policy in the USA (start of tapering – reduction in monthly purchase of assets by the FED, the American Central Bank, in Dec 13), motivated an enormous drain of Dollars from these countries, in a search of less risky assets (Flight to Quality). However, although this financial turbulence concentrated in the emerging countries, it also affected the more mature economies, a sign that the European economy will not take off as expected.

Therefore, we continue to face, with stubborn courage, the externalities (sung in verse and prose during all of 2H13) and our festering domestic problems – in fact, these are only a continuity of the constant we observed all through last year. We need to, as soon as possible, make the structural adjustments to adapt to the obvious and new scenario of economic cycle – it is the least we need to do to minimize the next period of "Interesting Times".

In any case, if the challenges are enormous, we (Brazilians) are capable of finding a way around things: with a little luck, some courage, humility, a sense of survival, recognize the errors in our economic policy and promote the necessary adjustments...this penny must drop...the only detail: it needs to be now!

With an uninterrupted sequence of reduced incentives to the American economy (Dec 13 and Jan 14), the Treasuries of the USA ended January at 2.646% and the S&P changed -3.56%. The NIKKEI closed at -8.45%; DAX at -3.40% and the FTSE at 1.19%. In Brazil, the Ibovespa ended January at -7.51% and the IBrX at -8.15%: With the maximum for the DIF15 at 11.89% and for the DIF117 at 12.92%. NTN-B 2050 ended January at 7.05%. The Dollar was quoted at BRL 2.4263 at the end of the month.

Economic Activity

GDP in 2013 remained far below the original promises and, unfortunately, we see no reason to believe the reality in 2014 will be any different. This taking into account the World Cup, which has the unequalled ability to stir up aggregate demand in the country… it will not be enough. The serious lack of confidence that hit businesses has the effect of stopping investments; suspicion of the public sector reached levels that are incompatible with the assumption of tolerable risks and the bleak spirit represses the drive of investors. Worse than this, are the financial crises (in particular international ones), which have been more frequent and more intense. In a globalized world, the fear of eventual ‘contagion’ becomes a major worry (example: Turkey). Following this line of reasoning, we note that, in general, the problems that set off each crisis are basically the same, but their effects have become increasingly more negative. Therefore, our estimates point to an economic activity for 2014 where the GDP will not manage to repeat the performance of 2013: we will grow somewhere around 1.64%. On the other hand, there is a remedy that, if it does not scare away or eliminate the external factors, at least will contribute to being better prepared: more investments and productivity! More competition! Better management of public spending and an increase in savings’s rates. This works.

OK, we do not have sunshine and music ahead, but at least we ended 2013 with unemployment at an historical low: 5.4% (without considering, for the moment, the new methodology). This is great! Particularly as real income (wages) was not ‘compromised’. And for 2014? Well, the situation will deteriorate somewhat but, in a year of the World Cup and Presidential Elections only a catastrophe could change this situation significantly...adjustments all postponed to 2015. This year of 2014 is a real challenge, a monster with seven heads! The challenge of having a better primary result; US ‘tapering’ and an eventual increase in the US interest rate; reduction in growth in China; domestic inflation at a high; low GDP, etc... And then there are the Presidential elections in Brazil. A reform has already started (or pseudo-reform, as all that happened so far was motivated by elections and not to effect a change in conditions). We are going to need several Samurai-Ministers to conquer this multi-faced dragon.

Fiscal Policy

At the end of last year, the President of the Republic anticipated herself and, once having verified the importance of Fiscal Policy for Brazil and the perception of investors, declared the four corners of the Government commitment aimed at maintaining the equilibrium of public accounts...which we consider as so much hot air. This is because; although the Government managed to 'improve' the consolidated primary surplus in 2013 – but with the use of non-recurring revenue –, the target for 2014 has not yet been announced. This is a pity for, more than a number in itself, there is still no confidence that the Government will not, once again, use creative accounting, or any other method, to fulfill its promise.

BACEN informed that the public sector's consolidated annual primary surplus was BRL 91.3b in 2013, or 1.9% of GDP – the lowest in the historical series started in December 2001. However, excluding non-recurring events, the performance of last year goes from 1.9% to only 0.6% and, when compared to the performance of 2012 (also adjusted: from 2.39% to 1.3% - net of non-recurring revenue and dividends from state owned companies) represents only half of the fiscal effort. Is this all? No! The more curious and amazing is yet to come: the Chief of BACEN's Economic Department stated that the evolution of the fiscal results of the public sector is a exogenous variable to the Institution and the definition of an expansionist or contraction in fiscal policy depends on the primary surplus...and, therefore, does not prevent the balance of the public sector from moving to the neutral zone (a reaffirmation of what has been said at other times). So good that the variable is exogenous...but the progression that there will be a movement to the neutral zone sounds suspiciously like a "support" of what the Government is doing. This cannot be, this cannot be done.

The bottom line is that the promises of the Federal Government, via the Annual Budget Law of 2014, with a primary surplus of 1.1% of GDP are absolutely insufficient. Let us wait, possibly until the middle of February, for the resonance to the speech of Dilma Rousseff and an extra effort on the fiscal front...everyone committed to our success, to discretion and care of public matters and the struggle, not only to persevere, but also to achieve economic victory, expect this outcome.

International Environment

Janet Yellen takes over the FED (US Central Bank) with a huge burden to normalize the monetary policy of the US, after years of interventionism (notably after Alan Greenspan stepped down). Truly a great challenge, but nothing new or surprising, as she always supported the ultra-accommodating policy implemented by Ben Bernanke. Therefore, no rupture and the transition will be absolutely in line with what we have seen until now – in fact, it was a choice made to give continuity to the monetary policy. Disappointing? No. Economists, as with all other professionals, have in their DNA sequence their origins and, consequently, a defined 'line of thought". Yellen is from the University of Yale, studied with the keynesian Professors James Tobin and Joseph Stiglitz, who published studies showing that markets are not efficient. What can be observed from Yellen's positioning is that she also believes markets need regulating...it is the mind set. Her husband, George Akerlof, who received the Nobel Prize in Economics, has the same way of thinking. The Vice-President of the FED will be Stanley Fischer, PhD from MIT, with a brief passage at the University of Chicago, but with works that combine rational expectations and rigid prices that might possibly lead to an imbalance in the markets and how a monetary policy can minimize these effects (neokeynesian models)

Great economists but, in clear-speak, it can be translated into "they are all a member of the same club". We can rest assured that nothing different will happen, because the plan is set out and the FED will not listen to the clamor of emerging markets claiming that US monetary policy should be conducted in a "coordinated action" with the their own. Forget that. It is history. A waste of energy; the polarization is complete: emerging countries on one side and developed on the other. The last few years have been a great bonanza for emerging countries and quite difficult for the developed ones....now it is their turn. And what about us in Brazil? Well, we need a 180 degree change in course in our macroeconomic matrix... difficult in an election year? Perhaps not, the difficulty really is in changing the DNA and consequently the "mind set" of those who leads us in economic policy.

Throughout world, it seems more and more plausible that China's rate of growth will slow down; inflation is at a record low in the Euro Zone and there is strong pressure on the currency of emerging countries. Chaos? Not so much, yet...we will study the next movements of the FED. Some members of the FED say they are attentive to market movements, but do not focus on the short-term. How ironic, when we think that Keynes most celebrated phrase is "in the long-run we are all dead".

Interest Rates

Of the two existing classes of economists, those that know economics and those that do not, it is normally left for those that advocate an increase in interest rates to combat inflation to be branded unscrupulous, insensitive to country growth, embezzlers of public property and often “friend of bankers”. Against facts there are no arguments, if BACEN wants to be the guardian of the currency (forgetting for a minute the other functions it has been attributed to over the last few years), there are fundamentally two options at its disposal: monetary control (money supply) or interest rates, period. We “chose” interest rates and, therefore, the natural rate of interest will have to be of equilibrium – whether BACEN leads the movement or whether it follows what the market prices in to the various vertices of the yield curve. This situation is made worse because the Fiscal Policy does not help, leaving the Monetary Policy to ‘deal with it’. With our model of “BACEN’s Reaction Function”, taking into account that this is an election year, we believe that COPOM will shorten the cycle of monetary tightening in the next few months. However, what it should do, really, is increase interest rates sharply. OK, one could argue that BACEN has increased the SELIC…but, it does not seem, in the eyes of Mr. Market, that the rate has reached equilibrium.

Foreign Exchange

It is common sense and a well known fact in the profession that forecasting the exchange rate is something which puts economists on their knees. However, the phrase with the greatest impact and currently more representative than ever is: “God invented the foreign exchange (forecasting the rate) to humiliate economists”. The BACEN continues (albeit timidly) to dole out its daily “ration” of operations on the FX market; the higher interest rate also has an influence, but the deficit in the currency account (external imbalances) and the present combination of extreme risk aversion and Flight to Quality (migration of resources to American Treasury Bonds), amongst others things, has already put very strong pressure on the FX rate at the start of this year. It is still early days, we have in our stress scenario a quotation at BRL 2.60/US$, but continue with a range of BRL 2.30 and BRL 2.40 for the end of the year. There are many external factors that interfere with the projection model. It really is a Divine humiliation – it makes us every day more humble.

The North American currency closed up 3.57% at the end of January, with the highest quote at BRL 2.4263.

Stock Market

To many, the Ibovespa's result of negative 15.5% for 2013 seemed to be the rock bottom, not for us...right at on the floor a trap door was found, it was opened and the Ibovespa plummeted. In this month, it has accumulated a loss of 7.51%, the lowest result for January since 1995! In only one month the Ibovespa dropped by more than half of the change of 2013. And it can drop even more. Fundamentally, our analyses pointed, and still points, to a larger drop, but the intensity of this movement was very strong and certainly has a technical component to it.

Here, also, we once again interpret the behaviour of the Ibovespa as a reflection of the Chinese deceleration; our domestic problems; the tapering of American economic incentives; rapid deterioration of entrepreneurial expectations which leads to the conclusion that the country will continue to grow at a low pace (our projection is for a GDP of 1.64% in 2014); higher inflation and interest rates and other considerations. However, perhaps a fundamental point is the reduction of foreign capital flow, because the foreign investors do not have confidence in the progress of the Brazilian economy. This is supported by the constant threat of a downgrade to the Brazilian credit rating. It is widely stated that the financial markets anticipates the facts...it could be...when it happens (if it happens) it will already be priced in (hopefully). Is this all? Wait and see? Of course not! We need to do all our homework, at the same time – "here and now".

These are audacious tasks to be taken, that shall be used conjunctively and with defined focuses, primarily conducted by the Government...here, well understood as being structural adjustments and less Government intervention in the market – all this reflects on the stock market. Obviously some will suffer but, as the late economist Roberto Campos would say: "you do not make an omelette without breaking eggs".

Always aware of these movements, various companies considered Value Companies, currently trade at a steep discount to their intrinsic value... we have repeated this almost as a mantra: Crisis = Opportunities. The qualities of a good model of investments in Value Companies, associated to patience and the possibility of long term investment strategy, usually result in excellent yields.

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