Planner Redwood Asset Management

MONTHLY COMMENTARY

MAY 2014

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Agenda

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

Introduction

Finally the time has come…the World Cup of 2014 is going to start! Is everything ready? Of course not! However, despite all the pitfalls and problems everything will turn out well...at least for the revelry...so we hope. With it being one of the most celebrated events in the world, the financial market could not keep its finger out and, every four years someone comes up with some sort of model of prevision and probability of winners and, with this, a 'betting book'. More than this, some studies (statistics, damned statistics) indicate how the market will react for the winner of the Cup. On average (according to the study by Goldman Sachs) the winner outperforms he global market by 3.5% in the first month, but "this performance is returned significantly in the following three months". In Brazil, our stock market went to 21% above the MSCI World Index in only the first month after the victory in 1994! Let us cross our fingers for it to happen again this year.

If the World Cup is a time that inspires many people, boosting markets and increasing aggregate demand, it's outcome is ephemeral in many ways and almost always a disaster for the Governments that invested in stadiums and other necessities (many examples in other countries and certainly in the case of Brazil). Demonstrations and "riots" will mark this event, not because the Brazilians stopped enjoying football, but because of the inappropriateness of the investments in face of the needs of the population as well as the widespread corruption that riddled this event. If in Brazil the World Cup serves to mobilize the population and blind us to our domestic problems, in Europe the recent elections served to highlight the lack of confidence in the European Union (EU). The dissatisfaction of the public with the economy manifested itself with some force in the elections. With 10.5% of the working population in the EU unemployed, living standards have stagnated in the Block and weak growth is compromising a good part of Asia and the USA. Nationalism seems to be on the rise in Europe. In fact, one can see the rise of these populist parties in many parts of Europe, some of them quite extreme…this does not look good. Something similar is happening in Asia...the Prime Minister of Japan, Shinzo Abe, struggles to pull the country out of 20 years of economic lethargy resorting, in part, to nationalist sentiments.

In the USA, a review of the published GDP shows that growth contracted to a rate even slower than expected in 1Q14 (fundamentally because of the extreme cold weather), but the details of the review show a favorable growth for the year – we maintain our estimate of a 3% growth in American GDP.

Treasuries in the USA closed the month at 2.46%. S&P changed 2.10%, NIKKEI closed at 2.29%, DAX at 3.54% and the FTSE at -0.71%. In Brazil, the Ibovespa closed the month down 0.75% and the IBrX down 1.12%. The high for the DIF15 was 11.01% and DIF17 12.23%. NTN-B 2050 closed the month at 5.99% and the Dollar quoted at BRL 2.239.

Economic Activity

The GDP for 1Q14 showed its face and it is very ugly! The published result for 1Q14 shows a difficult turn of events: consumption and investments contracting. In addition, the use of consumption as a growth factor has ended (as we commented in this space previously) and the alternative of a transition (another model) to investments suffers from a lack of confidence – in good part influenced by this year's election process. In fact, weakness can be seen in consumption, investment, industry, retail and in the drop in industry indexes – in other words, the move is very consistent and noticeable as much on the side of supply as on the side of demand.

Although too early to be sure, with these results the ghost of stagflation begins to rattle its chains…our projections for GDP in 2014, with the revaluations and adjustments to the model, point towards a growth of 1% - combined with an inflation of 6.7! On average, since 2011, Brazilian growth has remained at below 2% and inflation above 6%...a situation at its limit of stagnation and inflation (yes, because a scenario with stagflation is more lasting and difficult to reverse).

If this scenario of stagflation really gains force, what to do to get out of this trap of high inflation and very low growth? The answer is always more of the same: we need a symphony of Government and BACEN, of Fiscal Policy and Monetary Policy. The dissonance destroys the result sought after. What we see is an expansion of the former, accelerating one part of the economy with the later holding back the other part. In a scenario of 5% unemployment, such as we have, Government expenses (increase of 0.7 in 4Q13) pressure inflation to remain high, even with the BACEN holding the rest of the economy with its Monetary Policy.

Altogether, we have data of an investment rate of 17.7% of GDP (it should be above 22%), the lowest registered for the first quarters since 2009; a contraction in Gross Fixed Capital Formation (FBCF) in 1Q14 compared to 4Q13; a 0.8% drop in Industrial GDP; a 3.3% contraction in exports and 0.1% reduction in household spending, while the one lone "refreshment" in the agricultural sector is deceiving. In reality, there is no alternative: only with a large shot of credibility and a correction of the political economic paths, will Brazil manage to escape the trap of low growth and high inflation: No escape.

Fiscal Policy

We do not want to take a more skeptical tone than we already have, however, it does not seem feasible to imagine a significant adjustment on the fiscal (and parafiscal) side over the next few years, in particular that supported on reforms which reduce mandatory expenses. In fact, signs from the Government are contrary to the prospect of an adjustment in order to lower expenses, considering the announcement of the extension of exemptions on payroll – previously expected to end in 2014. In fact, the fiscal and parafiscal policies continue to be expansionist, with the BNDES paying out. In this way, the primary surplus in 1Q14 attained its target, but only by resorting to the postponement of expenses and a high use of dividends from state owned companies.

The great truth is that the scenario is even more challenging, because the rate of growth has affected Tax Revenue, now supported strongly by extraordinary revenue. Apart from the postponement of payments mentioned above, costs continue to grow at a rate above revenue. Evidence of this is in the published report on tax revenue, administrated by the Federal Inland Revenue, with a negative adjustment of BRL 7.2b to the original calculation (cancelled by "other administrated revenue" – REFIS). The postponement of expenses in April was marked by the non-payment of precatorios (documents issued by the Government guaranteeing payment of a set amount) and by tax revenue. Given the weak growth in collections from income and social contributions, the Government had to resort to State owned companies to reach its target.

With the result from April, the Central Government's primary surplus reached BRL 79.4b in the accumulated 12M – equivalent to 1.6% of the GDP. Adjusting (excluding) revenue from Libra auctions and REFIS, the fiscal primary surplus comes to 0.87% of GDP. If we add the State Governments and State owned companies, the consolidated public sector presents a 12M accumulated value of 1.87% of GDP (in line with the target of 1.9%) but, if adjusted, the result drops to 1.14% of GDP – a clear sign of the difficulties in meeting the annual target without a large amount of extraordinary revenue.

In summary, the Fiscal Policy does not appear to have the day-to-day glamour of the Monetary Policy, but it is extremely important for the medium and long-term. In addition, the promises and good intention of the beginning of the year have not been confirmed, because the execution of the Fiscal Policy is, at the best of hypothesis, precarious and insufficient to re-conquer the lost credibility...a fundamental factor for the country's economy.

International Environment

Between January and March, the US GDP dropped to 1.0%, notably due to the harsh climatic conditions, which hindered business and slowed down the construction sector. The reduction in inventories was the main factor responsible for the contraction, but expectations are for a robust growth in the next quarters, with GDP for the year forecast at 3%. In this context, discussions as to the increase in interest rates gain more elastic previsions, in particular because they depend on economic prospects and this is inextricably linked to inflation. In our understanding, somewhat contrary to market expectations, we do not rule out increases already for this year (this measure reflects immediately on our economy and therefore the management of resources) and in the next few months a more accurate estimate will be incorporated in our models.

In Europe, weaker than expected manufacturing dada for the Euro Zone and the low inflation in Germany boosted expectations that the CBE will begin, at the next meeting this month, new monetary easing policies. The May industrial purchase managers index (PMI) for Europe is worrying for the Euro Zone, the PMI dropped to 52.2 in May, from 53.4 in April. The consumer price index in Germany retracted 0.1% in May against April and increased 0.9% on an annual comparison. The results fell short of market expectations. After the elections, the center left party of the Italian Prime Minister, Matteo Renzi, was victorious, with requests for greater flexibility in the policies dictated by the European Union. On the other hand, the French socialist government did not have a good performance in the elections and now faces the challenge of balancing the needs of the EU with a restoration of the popularity of the government. On this same note, the Commission asked that Italy reinforce the budget measures this year to reduce debt and pressured France to detail the measures taken to guarantee a correction of the excessive deficit, for this and next year. Spain also received a recommendation to detail measures to reduce its deficit but, according to the EU, the incentive measures in the country “seem to be in line” with the recommendations from Brussels. For Germany (the Ant, from the fairy tale “the Cricket and the Ant”, where the former sings and enjoys itself and the latter works: was simply given a request to seek a Fiscal Policy “friendly to growth” and improve domestic demand. It would be good if the behavior of the German (The “Ant”) could migrate our way.

In Asia, the Japanese PMI accelerated to 49.9 in May, but numbers below 50 indicate a contraction in industrial activity. In China, the Government has promoted cuts in compulsory expenses, but states that this does not signify changes to the Monetary Policy…in the same way that the massacre of Tiananmen Square never happened.

Interest Rates

The truth hurts, but sets us free! The election polls stir up the markets and society. How wonderful!

Therefore, the interest rate market was also influenced by election polls in May. The possibility of a change in government contributed to the decrease in the yield of the interest curve. The crisis in the Ukraine had treasuries losing strength; the 10-year Treasury bonds index (a benchmark for the market) reached its lowest level of the last 6 months and contributed to knocking down the futures long-term interest curve. Lastly, the publication of the Brazilian GDP for 1Q14 on the last trading day of the month gave momentum to the drop in the futures interest.

The futures curve started the month with bets divided on the COPOM meeting. During the month the bets for no change gained a majority, because inflation indexes were published giving some breathing space, as well as because of the BACEN economic activity index for March, which pointed towards a drop in activity. For us, this topic was the least “debated”…we are convinced that the SELIC will remain at 11%, at least until the end of the Presidential elections. Period. April’s IPCA (0.67%) was in line with market estimates and exactly what we estimated – we hit the nail on the head! Inflation tends to cool down in May and June; a well known seasonal movement. However, price pressures continue and the risk of inflation punching through the -2014 target upper band is very real – in fact, we forecast it at 6.7%. Similar to the movement of the interest rate term structure (ETTJ), the inflation curve had its real yield reduced along all the vertices.

Foreign Exchange

Predictability is a fundamental factor in economics and is normally conquered with measures and structured sequences of policies and actions – it is no different for the currency exchange market. This does not rule out a possible change in course, always beneficial, but as long as the “north” is not diametrically changed...which causes volatility and unpredictability. It was not only the international pressures (Ukraine, Chinese economy, difference in international interest rates etc.), domestically we had the results of the public sector accounts and, fundamentally, doubts on the continuation of the auctions (BACEN states there is a cooling demand for swaps) and, in this way, a clear sign that the BACEN could interrupt the Dollar auction program often announced as a “policy” for 2014. The great irony: the rationale is that BACEN can go to the auctions only when necessary to control the volatility of the foreign exchange...OK, congratulations...they can return to them, because the measure already brought volatility (and an increase) in the foreign exchange market.

Stock Market

More of the same: the election polls continue to trigger the domestic financial markets. For the market, a change in Federal Government from 2015 is a good thing. Polls against the current administration boost the stock market, those in favor cause it to slump. In the middle of the month, the Ibovespa reached 54,000 points, a level previously reached in November 2013. However, on the eve of another election poll, rumors of stability for President Dilma brought the exchange down to 52,000 points. With the release of the GDP on the last trading day of the month, the sharp drop in the price of iron ore and the retraction in the financial sector had the Ibovespa lose all the gains of the year, accumulating a drop of 0.52% and ending the month down 0.75%.

GDP for 1Q14 was in line with market consensus. However, the opening of the data is worrisome. Family consumption dropped and inventories increased, indicating an even worse performance for the next quarter.

The increased supply of iron ore (mainly from Australia) and concern for a lower than anticipated increase in Chinese economic activity, slashed the price of iron ore and, consequently, the price of Vale's share (Brazilian mining company).

The banking sector also did not have a good performance during the month. The preliminary decision of the STJ (Superior Court of Justice), giving support to the cause of savers in relation to the correction of savings accounts during the economic plans of the 80's and 90's, caused the price of bank shares to drop. The indefinite postponement of the final judgment by the STF (Federal Supreme Court) only brought a momentary relief to the shares.

The electric sector continues to cause concern. The rainy season has ended and the reservoirs remain low. A reduction in usage and/or rationing of consumption becomes necessary to re-balance the sector. However, the probability of this happening is low, given the political component.

The government once again demonstrated its lack of credibility in postponing the increase in tax for soft drinks, interfering with the shares of Ambev.

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