Planner Redwood Asset Management

MONTHLY COMMENTARY

AUGUST 2014

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Introduction

The imponderable is part of our lives.

As in finance, where we map risks and extreme situations, in other areas of life we prepare and try to mitigate risks and reduce the likelihood of undesirable events with all sorts of precautions. This is not always possible, and we are often amazed and try to readjust to the new reality. So it was with the tragic plane accident that killed presidential candidate Eduardo Campos. The event, in addition to being extreme, "disorganized" the presidential race and, interestingly, puts his running mate as a candidate for president, with strong likelihood of success. Does this pose a problem? Before we had two candidates most likely to win the election, with well-defined political bases, now, with the possibility that Marina Silva will become the President of the Republic, it is not known for sure which political agreements will be done, by whom, to eventually ensure governability while in power.

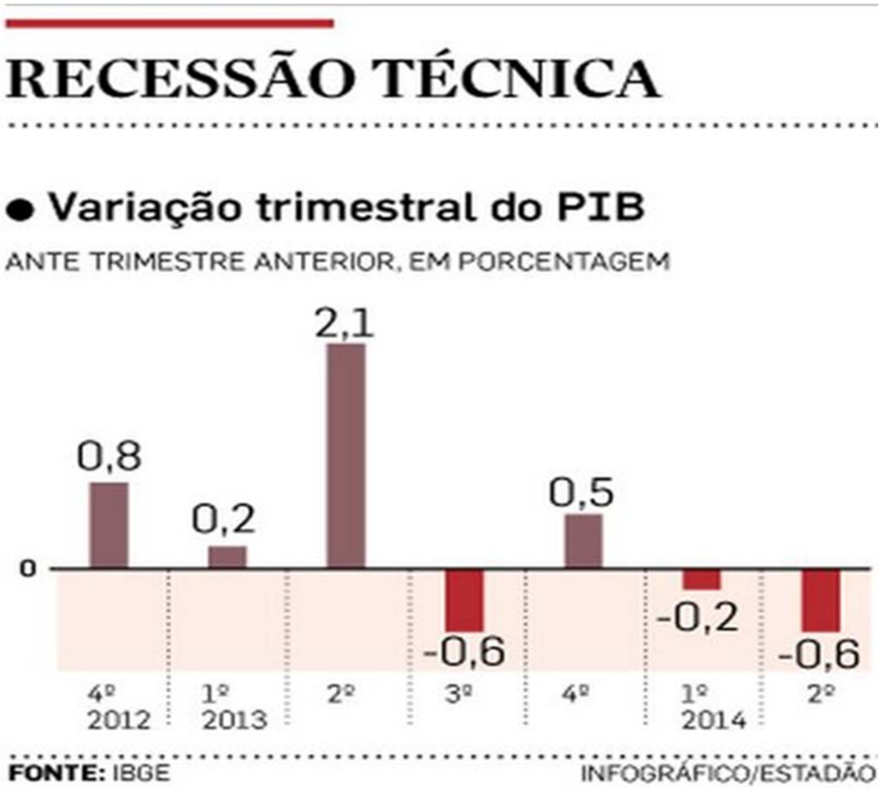
In the domestic economic front, apart from the agricultural sector, which still continues to hold the fort, service and industry sectors disappoint. Thus, the Brazilian economy slowed 0.6% in the 2nd quarter, and the first quarter performance was also recalculated to a negative performance - economists worldwide formally admit there is a "recession" when there are three consecutive negative performance quarters. Unfortunately we're almost there.

In the international political scenario, tensions also seem to cool off in the Ukraine crisis, and there is a ceasefire in the Middle East (Israelis and Palestinians). The world's economy remains divided. On the one hand the American economy is performing well (the American GDP was revised from 4% to 4.2%) while in the Eurozone, there is zero growth. In Asia, we have more of the same, as China (Government) seems to be on stand-by for reassessment of its policies (especially monetary), in light of inflation and growth data.

Both the domestic political scene (confusing, but indicative of changes in the status quo) as the international situation have caused changes in the markets. In this scenario, the US Treasuries ended the month at 2.34%. The S&P changed 3.77%, NIKKEI closed at -1.26%, DAX with 0.67% and FTSE, -0.58%. In Brazil, the Bovespa index ended the month at 9.78% and IbrX, 9.59%. Maximum for DIF15 was 10.87% and for DIF17, 11.86%. NTN-B 2050 ended the month at 5.48%, and the dollar traded at R$ 2.2396.

Economic Activity

Criticisms are always welcome, but some statements (even without scolding or impoliteness) should be avoided. The declaration by economist Maria da Conceição Tavares that "people do not eat GDP" is one such example. We have already criticized different approaches to measuring "wealth and happiness" of a country. The destructive approach of the concept (even if accompanied by results in the social arena and the level of unemployment) does not hold in the long run because the indexes converge ... there will be an adjustment and/or rebalancing in employment, GDP, inflation etc... The graphs below speak for themselves:



It is said that a picture is worth a thousand words ... but the time of change is coming and the country will again seriously conduct its economic policy. In fact, one does not "eat" GDP ... because even if it were so, we would not have enough to eat.

Fiscal Policy

It seems that the folks in charge of Fiscal Policy pressed the "I don't care" button.

The Treasury disclosed the results up to July: a R$ 2.2 billion deficit! Using the 4-month calendar it will be virtually impossible to meet the target of R$ 39 billion for 2014, for, as of July, the Central Government accounts balance posted only R$ 15.2 billion ... this July, we had the worst month-result since the start of the series in 1997.

This cursed legacy of terrible results will be left for the next government to resolve, whatever it is. At this point there are two alternatives: (i) if the current Government continues, there should be a radical change of posture, to try to minimally reverse expectations and resume, somehow, the confidence and (ii) if there is a change of Government, and therefore, there are different prospects than the current ones, there will be new "credit" or "restoration of some confidence" - fundamental to reverse the current expectations and inflection of investment trends.

The great problem today, if Government continuity is maintained, is not running smaller fiscal surpluses. The main problem is the loss of credibility of repeatedly not fulfilling what has been promised. Moreover, the creative accounting measures, extraordinary revenues and other things such as delayed disbursement of transfers and benefit payments (even within accounting limitations) have a very bad impact on the defense of the credibility and seriousness of actions and purposes.

Finally, the economic recession and the slowdown in tax collection is so blatant that it becomes impossible to circumvent and keep a business as usual attitude. The frustrations of the Government forecasts invariably affects the Government itself under several fronts - that is, it is impossible to ignore a review ... which is realistic this time. In hindsight, this people cannot afford to press the "I don't care" button.

International Environment

Not even the earthquake that struck the west coast of the USA seems to have sufficiently shaken the FED's rationale that a change is warranted in monetary policy. Yes, even with expected inflation, unemployment and the resumption of economic activity (the key variables used by former chairman Ben Bernanke as indicators of change in FED policy), the leaders of the FED did not change their current policy. The FED's rules of governance and transparency of actions go hand in hand with its policy implementation, but the evidence suggests a change of posture should take place very soon. In fact, besides being what we believe (and try to prepare for the consequences arising from the expected changes), the sooner it happens, the better. Yes, it will be better for everyone, because although the change of FED policy will have negative impacts (especially for emerging countries), facing this problem now implies smaller losses than later, especially for us Brazilians, even better considering the possible political, economic and financial changes in 2015.

In the EURO Zone, the consolidated performance of economies was weak (GDP with zero variation in the three months ending in June compared to the 1st quarter), and annual inflation is 0.4%. Italy, which entered into recession, is a negative highlight, while, on the positive side, Spain grew 0.6% in the 2nd quarter. Other good news is that the composite PMI (purchasing managers index - industrial and service sectors) of the EURO zone rose to 53.8 in July (1 point expansion in relation to the previous month). Given this scenario, the ECB (European Central Bank) will soon strengthen the interventionist practices with the purpose of "warming up" the economy, even if this is only useful in the short term. In a preliminary reading, HSBC disclosed the PMI of the Chinese industrial sector with a reduction from 51.7 to 50.3 in August ... a clear indication of growth moderation. If there are concerns about the growth of the Chinese economy, the world needs to be aware ... particularly emerging countries.

In the economic and financial world we can find the most weird and complex theories and analysis with different impacts, but tsunamis and earthquakes do not seem to be any correlation and/or cause and effect relationship (besides eventual momentary regional financial aid) with economics and finance practice. Actually, its not any “quake” that will wake us up."

Interest Rates

Fixed income continued to bring joy to investors in August.

The premia of future interest curve vertices maturing from January 2017 were reduced during the month. There was more intense activity in the long part of the curve (vertices as of 2018) with the entry of foreign investors. Risk aversion decreased with increasing of likelihood of an opposition victory in the October elections - especially the fact that Marina Silva, now a strong candidate, discloses her economic policy with restructuring ideas and how these will be implemented - which is music to the ears of the market.

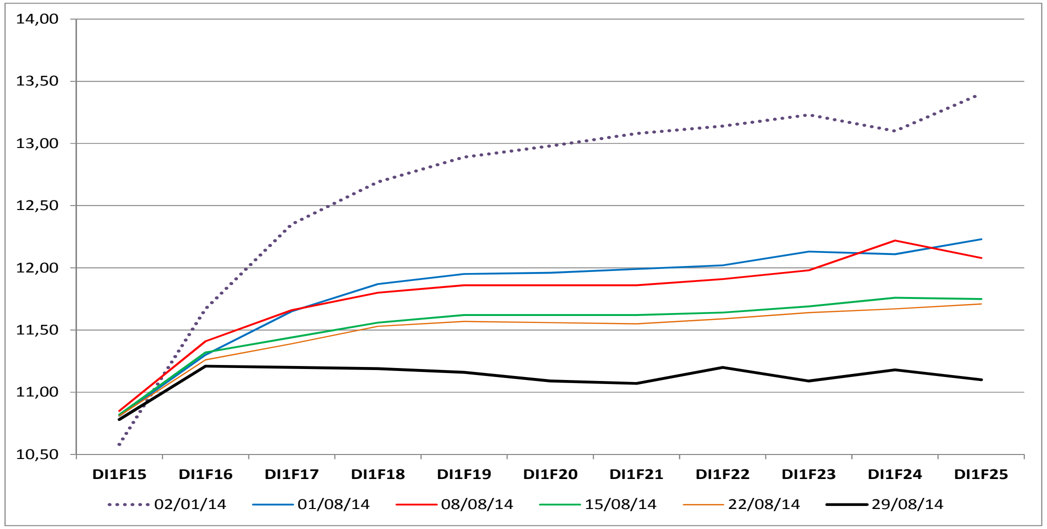
The month's surprise was the result of the July IPCA, that was 0.01% below all market forecasts (including ours), causing the 12-month inflation to turn back to the ceiling target. With the end of the World Cup, personal and transportation expenses were cheaper and favored low inflation. However, the joy should be short lived, for in the next month the energy increases and the still high rate of inflation diffusion index must weigh in the calculation.

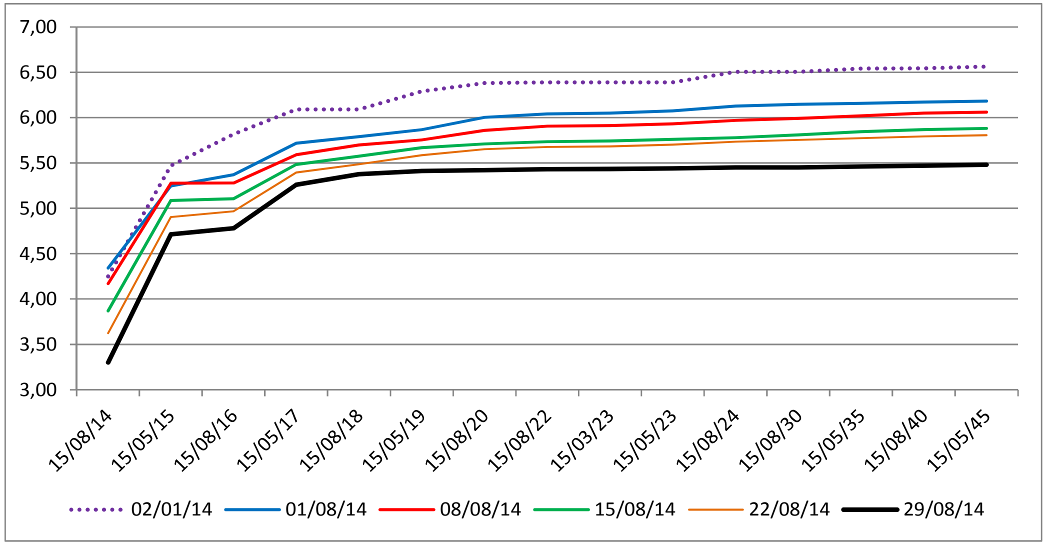
Going against the expected and timely monetary tightening, but in absolute line with the economic thinking of the current government, the Central Bank (BCB) announced new measures to encourage lending in order to boost the economy. From a technical point of view (which should prevail in the Central Bank), as mentioned in previous reports, the credit expansion measures have little effect given the exhaustion of this "model" along with the other variables, as well as the position of borrowers, whose credit appetite has diminished. A reflection of this low interest is the high consumer income commitment and low confidence in the economy. Among the measures introduced by the government, all important and appropriate in mature economies, are: the Guaranteed Real Estate Notes (Covered Band) free of Income Tax, allowing the use of paid-off real estate as collateral for loans, increased bank guarantees and reduction of red tape for the repossession of the asset in case of default. Excellent! Later on, when the economy is back on track, this will be even more useful.

Finally, as for the economy's basic interest rate and the Central Bank's posture, we have serious doubts ... for the secondary market investor (especially in Government Securities) the buyer's joy is huge ... if it gets better, it will turn into a party!

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

High volatility in the foreign exchange market.

Like the interest rate curve, there was a reduction of USD coupon across all maturities, reflecting the increase in implied inflation up to 2017 and reduction thereafter.

Whether due to the geopolitical tensions in Eastern Europe and/or the Middle East (possibly at a reduced intensity), or weaker Chinese activity data and/or stronger American economy (possibly at a greater intensity), but undoubtedly due to change of the Brazilian electoral scenario, after much volatility, the Real closed the month trading at R$ 2.242, compared to July's closing, R$ 2.27.

The Central Bank tried to hold back the appreciation of the dollar at the beginning of the month, with increased roll-over of foreign exchange swaps to 10,000 contracts, however this offer was not sufficient to change the currency's trajectory. The appreciation of the Real occurred with the disclosure of polls indicating a possible runoff, and later, with Marina Silva's entrance as a PSB candidate for the presidency. The increased likelihood of non-reelection of the current government encouraged foreign investors, who came back to the Brazilian market. The market's assessment is that the change of government can restore confidence in the country and improve the inflow of capital. It is too early to celebrate. The stance of the FOMC (signaling American interest rate increase) in the coming months will be determinant in regards to the flow of capital to Brazil.

The Central Bank will continue to try to "control" the volatility of the exchange rate...will it really? Or will it try to control the price to mitigate inflationary pressures from foreign exchange variation? It is difficult to understand ... "burning" reserves now (even if they are robust) on a future in which there will be a Flight to Quality (return of investments to American bonds)? The best thing to do is to face this stress scenario with strong reserves.

Life can and will get more difficult for the foreign exchange rate policy as soon as the FED begins to make adjustments to its policy.

Stock Market

The Bovespa Index ended the month above 61,000 points! The Marina Silva effect!

Marina Silva did what former President Lula did before his first election: she published a kind of "Letter to the Brazilian people." The candidate maintains her discourse in favor of Central Bank independence, and an economic tripod: inflation targeting, a floating exchange rate and balanced government accounts. More than that, she commits that she will not use state owned companies as macroeconomic policy instrument, introducing the idea of creating an independent body to assess fiscal policy!

The market, which prefers any candidate to President Dilma, celebrated this proposal and ended the month with a Bovespa index 9.78% gain. Thus, the stocks of government-linked companies had strong appreciation, while others were more focused on behavior that actually impacted their performance. In short: these abrupt valuations without any change in the fundamentals of the companies, are not sufficient to ensure a really consistent and sustainable high ... obviously the market prices in every possible movements and changes in the companies, but the recovery of the "destroyed value" takes time and governance and management practices are mandatory to confirm the new prices.

Anyway, were it not for the Marina Silva effect, considering the second semester's GDP data and all other economic indicators, under normal market conditions - that is, without presidential elections in sight - the Stock Exchange would have had a strong meltdown ... but the opposite happened. For the financial market, weak performance data is negative for the re-election of President Dilma, and reinforces the position of an opposition candidate, which in turn brings relief and hope for a new business environment.

This is the situation at hand.

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