Planner Redwood Asset Management

MONTHLY COMMENTARY

JULY 2014

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Introduction

The FIFA World Cup has come to an end! Everything worked out: there were little strikes and riots, airway transport did not fail, the stadiums did not crumble and security worked well. It was a football extravaganza, apart from the crushing defeat and melancholic exit of the Brazilian team. Yes, the embarrassment could have been worse if not for the gentle elegance of the Germans by reigning in their goal marathon, out of respect towards our tradition and because we were the hosts. Now that the party has ended, we return to reality and the enormous bill we have to pay.

If our results in the Cup were not good, in the economic and political game the score against Brazil is daunting. In these arenas, the opponents have no pity and the pounding is merciless…there is no truce. In this game we cannot wait for the final whistle, hoping that we get a good jolt and realign our path. Unfortunately, this seems unlikely and, at this stage we should be heading to extra time. The biggest concern here is that, as in the Cup, we will be able to at least reach the end of the championship. We cannot allow various political and economic achievements to collapse and, unlike a game of soccer where the opponent can continue to score goals with the coach having only a few substitutions, here we can change the whole team.

Around the world, this was a month of great tragedies, such as aircraft disasters and the insanity of interminable wars and conflicts, between Israelis and Palestinians and the within the Ukraine. All are devastating but with a small impact on world economy (perhaps one of the reasons for the lack of definitive solution) and specifically on Brazil. In the Euro zone there are no significant changes and in China industry shows signs of some recovery. In the USA, the economy grew strongly confirming expansion for 2014.

In Argentina, the game looks to be coming to an end for the 2nd time in 13 years! Default is imminent and the consequences are even greater. The market is already feeling the ripples with the Credit Default Swap rates (CDS – measure of country risk) shooting up to 3000 points. Independent of the reasons for the situation, the reality is of extreme difficulty for the hermanos. We expect a small, but some, negative impact on the Brazilian economy given our commercial relations, but cannot imagine the contagion spreading to other countries in Latin America. Investors know how to identify the focus.

In this scenario, the Treasuries of the USA closed the month at 2.55%. S&P was down 1.51%, the NIKKEI closed at 3.03%, DAX down 4.33% and the FTSE down 3.35%. In Brazil, the Ibovespa ended the month at 5.00% and the IBrX at 4.46%. The high for the DIF15 was at 10.79% and DIF17 at 11.51%. NTN-B 2050 ended the month at 6.11% and the Dollar at R$ 2.2674.

Economic Activity

The deceleration is, definitely, very strong.

In our revision of macroeconomic scenarios, we depart from a forecasted expansion of 1.64%, to 0.77% for 2014. It is a disaster. Recently, the International Monetary Fund (IMF) placed us in a position of moderate fragility (a moderately fragile position in relation to medium and long term fundamentals) and now, amazingly, even ECLAC (Economic Commission for Latin American and the Caribbean) has placed us in a similar position...according to ECLAC calculations, Brazil's growth will only be higher than that of Venezuela and Argentina...just as a reminder: Argentina is at the brink of default and Venezuela...well, Venezuela does not count. Hang on! Our growth will be level with Cuba's. Good Lord, this is inadmissible.

The factual reality is undeniable: data from industry, capital and durable goods and construction indicate a bad result for 3Q14 and annual forecasts reflect this. Nothing helps, and the Government, instead of admitting mea culpa and implementing adjustments insists on its current economic policy...it blames contraction on the global economy and does not look beyond its nose to see that the biggest cause are our domestic troubles. Without sugarcoating the situation, the confidence indices continue to drop and it is not possible to guarantee a sustainable GDP growth without a recovery in confidence, boosting investments and domestic savings incentives, which apparently will only be possible with a comprehensive change to our economic policy.

The film about the life of the Nobel Prize winner (Economics) John Nash, entitled “A Beautiful Mind”, shows all his suffering with his illness (schizophrenia) and how he had “visions” of people who accompanied and talked to him. These were so real he could not admit they did not exist...he did not believe anyone when they told him otherwise (family, friends, and bosses). However, as time passed he began to give credit to what he was told and, smartly, began to observe the facts. He realized that the visions of people by his side could not be true as they never aged, and that made no sense at all! Without delay he accepted that he had hallucinations (although the visions never stopped) and spent the rest of his life bearing this fact.

The forecasts made by independent economists, Consultant Companies, International Organizations, Banks and so many others do not project Brazil growing at the rates the Government does…they have very different views.

The question is: who is the schizophrenic here?

Fiscal Policy

Brazil has its lowest surplus in its history!

It will not be possible to reach the primary surplus target for 2014. Even with the cleverest and most creative accounting methods the Government's objective is not in range. It is gone.

The consolidated primary surplus of the public sector was 43.67% below that of the first six months of 2013. The combined savings made by the public sector (Federal fiscal efforts, Central Bank, INSS, States, municipalities and State-owned companies) was R$ 29.38b in 1H14, or 1.17% of the gross domestic product (GDP). In the same period of last year the surplus was R$ 52.1b, or 2.23% of GDP. This is reckless spending, an unprecedented madness. This is not shallow criticism and/or a mindless attack. No. It is an unequivocal statement of generalized incompetence at the limits of responsibility, for it borders on a disregard for the treatment of one of the crucial variables in interpretations of our fundamentals.

However, if public accounts are in a butchered state, even worse is the strict mentality apparent in the BACEN's declarations on this topic. Even after presenting the bad performance of consolidated public accounts, the Central Bank maintains its argument that its fiscal policy heads to the neutral camp. Again? Come on! And there is more: it declares that the recent fiscal results do not alter the vision of BACEN with respect to possible impacts on monetary policy. It says: "What is relevant is the fiscal momentum". Things are already pretty bad, perhaps it would be better to retract and come up with a more constructive statement.

The Secretary of the Treasury, Arno Augustin, continues to promise that the target will be reached…he promised this last month, when presenting May figures, and continues his optimistic display. To justify his optimism he mentions the expectation of greater economic growth for 2H14, with greater collection of taxes and contributions, as well as input from 'special' revenue (sure!), such as payments of the new Refis starting in August. For the Minister of Finance, - there is an artificial pessimism in Brazil, generated by non-economic factors and in 2015 we will have a better year. Oops! We seem to have an alignment of speeches.

It is difficult being called pessimists (at least we admit to being genuinely pessimistic), but in the "relevant horizon" of the current economic policy, the only thing we see at the end of the tunnel is the oncoming train …at high speed.

International Environment

If last month we presented the reviews of numbers regarding the American economy for 1Q14 which were very low due to the extreme cold weather in the country, now we report that the preliminary results for 2Q14 are even better than expected: 4%. This result is in line with expectations for the year, but do not seem to affect the FED (American Central Bank) even to signal some alteration to its economic policy. In fact, the always dovish arguments of the majority of the members of FOMC (Monetary Policy Committee) were once again in the tone of its communications (a few more hawkish arguments begin to appear) and all remains the same...tapering (reduction in the volume of asset purchases) at the same rhythm, interest rates, etc....we do not agree with this...any minute now the FED will be behind the curve (lagging in relation to the market) and an adjustment will be inevitable. The truth is that the market already started to price in these future alterations.

In opposition to the American market is Europe, although contrary to what we expect in changes to the USA monetary policy, we can see the CBE (Central Bank of Europe) at the brink of starting major incentives in the Euro Zone...the film seems to have the same story line as in the US. This is because the fundamentals simply do not change... unemployment, inflation, economic activity, etc.

In China, the industrial PMI (HSBC) increased from 50.7 to 51.7 in July, while in India the same indicator increased even more: from 51.5 to 53. As always, the highlight is on the German industrial PMI, which increased while the indicator for the Euro Zone remained flat. For Italy, France and Spain, the industrial PMI dropped, and the worsening of the indices for these countries is an important indicator in the process used by the BCE in its decision taking. The fact is that economic recovery has not been consistent.

The international situation with regard to the political and social environment, despite limited global economic impact, seems to gain regional importance in the case of the crisis in the Ukraine, due to the increasing involvement of Russia. The sanctions imposed on Russia will have an impact and the reprisal will not take time to come. Therefore, a ‘regional’ conflict has the potential of causing a much larger disturbance affecting the whole world. The situation is far off, but care is important so that we do not relive the era of the “Cold War”, when constant fear and the fragility of relations caused innumerable difficulties to economic growth and the well being of societies.

Mankind does not need to go through that again.

Interest Rates

We have recently noticed changes in the so called “macro prudential measures” taken by BACEN, mainly with regards to its interpretation and adaptation to the current economic scenario. It is said that this macro prudential policy aims to increase financial stability, to moderate excesses, etc., while the monetary policy aims to guarantee stability of prices and uses other channels. Be it semantics or not, BACEN can legitimately make the use of the “two policies”, but the result is the same…it should not use one to achieve the aims of the other …increase interest rates or reduce liquidity of the system? The end result is the same.

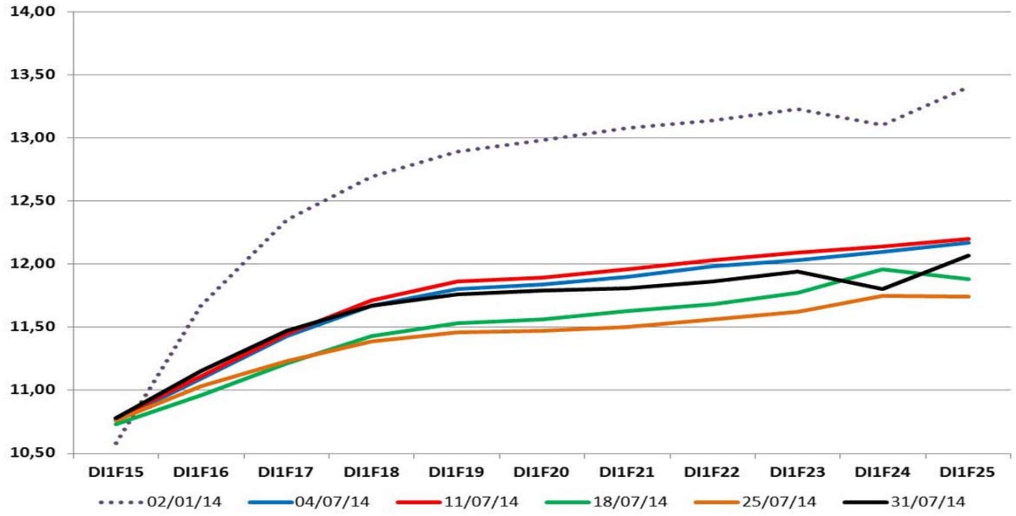
Possibly as a reflection of whichever of the policies, the fact is that the yield curve (Risk Free Interest Rate) always reacts. In this way, the downward trend band of future interest rates did not have the strength and so, as did other markets, reversed its movement during the last week of the month. Part of the return seen in the portfolios of those investing in fixed rates or treasury bonds indexed to inflation, and who did not back off from or hedge their position, suffered badly. The reduction in premia at the start of the month was a result of various factors: (i) decrease in the Brazilian industrial PMI; (ii) profit taking and (iii) increased price of the Real. However, the scenario changed due to increased risk aversion and the premia increased.

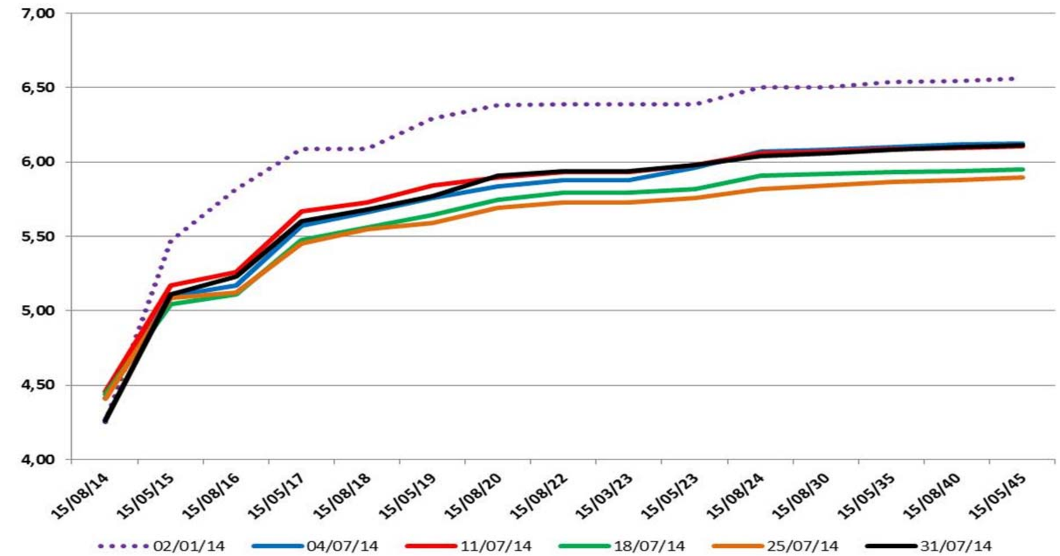
The July meeting of the COPOM did not surprise us, as we are convinced that the SELIC will remain unchanged until the end of the year (or at least until the end of the Presidential elections), despite the accumulated 12 month inflation of the IPCA in June remaining at 6.52%, above the ceiling of the target. This theory is reinforced by the minutes of the COPOM meeting, which endorsed the statement by affirming that the interest rate does not drop while the process of convergence of inflation to the target is in progress. With this, the term structure of interest rates reacted by increasing yields along the whole of the curve, having also contributed the increase in Treasuries and the deteriorating reaction of the fundamentals of the Brazilian economy.

In line with its policies, the Central Bank implemented some monetary expansion measures through compulsory deposit, with the objective of boosting the credit market. However, what we see in the market is a lower demand for credit by companies, which are wary of increasing investments. It seems that the end “clients” do not want to board this train.

Interest Rates

Yield and Cupons Curves (NTN-Bs)





Foreign Exchange

As always, the FX is an extremely difficult variable to forecast – “the foreign exchange was invented by God to humiliate economists” said Edmar Bacha.

Will forecasts for the FX have to be reviewed? Was the stress of the last week of July punctual, or did it indicate a new trend? According to data available, we believe it punctual, only a risk aversion movement. The projections of our models for end 2014 remain at R$ 2.30 – R$ 2.40.

The current account deficit is at approximately USD 80b and, with the present flow of capital, the Real should depreciate but we do not bet much on this as, if it is to happen, inflation would increase even more. This is the reason BACEN uses swap intervention in the foreign exchange market, to hold back inflation and avoid an adjustment of current accounts... but we all know this will happen sooner or later. In this case, later: 2015.

For the short-term we have the following: the devaluation of the Real against the Dollar followed the movement of the currency in other countries. The crisis that hit Banco Espírito Santo (BES), the largest financial institution in Portugal, contaminated the markets. At first glance, the worry about the impact of this crisis on the Euro Zone triggered a global movement of risk aversion, with investors moving to the protection of the Dollar. However, intervention in BES by the Central Bank of Portugal brought some relief to investors. The geopolitical side contributed to tensions with the new sanctions imposed on Russia and the Israeli invasion in the Gaza Strip. Will the short-term influence the long-term? It depends on the escalation and/or longevity of the “conflicts”.

On the other hand, the certainty is that the eventual change in the economic policy of the FED, through an increase, or even the signaling of an increase in interest rates, will cause devaluation of the Real and of various other world currencies. In this way, the declarations of the President of the FED left the financial market confused as to the next moves of the institution. This is because, despite reaffirming the continuity of the current policy (it understands that the economy has not yet recovered completely and inflation is below target), the market does not believe that it will continue, given the American economic indicators. All this - admits that communication, a mode of transparency, is a fundamental element to the policy of any Central Bank.

The humiliation continues.

Stock Market

The World Cup has ended and the year has started: Onward and upwards to 60,000 points for the stock exchange. This was the feeling in the first three weeks of the month. However, as nothing fundamental has changed in Brazil, the last week of the month was one of profit realizations and the Ibovespa closed the month at 55,829 points, up 5%, after five-trading-days accumulated a loss of 3.59%. It seems a self-fulfilling prophecy for the stock exchange of the host country of the Cup.

Less prophetic and more cause-and-effect is the correlation between the election polls for President of the Republic and the movements of the stock exchange, FX and interest rates. This month, some polls pointed to a technical draw in the second round between the current government and the candidate of the PSDB. The possibility of a change in government brought euphoria to the markets, with the stock exchange going up, future interest rates going down and the Real increasing in value. There is nothing cooler than a mapping of future expectations translated into present day reality. Even the historical defeat of Brazil at the hands of the Germans, at the semi-final of the Cup, contributed to the stock exchange's upward movement. The interpretation of the market was that the terrible performance of Brazil on the soccer field could have an effect on voting in October. Cruel, but true...a losing team needs change.

In line with this change to the better, the shares of various state controlled companies increased in value: Petrobras, Eletrobras and Banco do Brasil. Even for banks (including private banks), a revision of potential loss estimates consequent of the correction of economic plans from R$ 441.7b to R$ 21.87b had the shares of financial institutions increasing strongly, contributing to an even greater increase in the Ibovespa given the significant weight of this sector on the index. It is not a coincidence that the present methodology used in our Value Fund does not include the banking sector (differentiated evaluation) and we removed ourselves, as far as possible, from "non-autonomous" companies. Bad for this moment, but we are managers and not fans or spectators. Risk? Yes. Uncertainty? No.

The last week of the month was ripe with news, mainly foreign, which weighed on the stock market: Weak corporate balances of companies quoted on the NYSE, imminent default by Argentina, financial crisis of the main Portuguese bank, uncertainty as to the timing of an increase in American interest rates and some effect from the geopolitical crisis in Western Europe and Middle East. In contrast, the American GDP closed up in 2Q14 and in China increased 7.5%, after incentive measures taken by the government. Now, onward to the Olympics!

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