Planner Redwood Asset Management

MONTHLY COMMENTARY

MARCH 2014

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Introduction

Here is the one million Dollar question (and its derivatives):

Are macroeconomics, politics and the financial market related? If yes, how do they integrate and what are the determining factors for each one in scenarios where all variables are in dynamic change?

The Real Plan, the Law of Fiscal Responsibility, the strengthening of our institutions and many other important measures in the Fiscal and Monetary camp were implemented more than 20 years ago. However, some have been constantly altered in the last few years; particularly the macroeconomic matrix, which we debate so often in this space. Result: Brazil has just been downgraded by the risk agency S&P to the BBB- level, the lowest level considered the so celebrated Investment Grade. The consequence: lower appetite for long-term investment in Brazil.

In more and more polls are coming out on Intention for President and, in this area, although the chances of Dilma Rousseff being re-elected are great, one can no longer assume her victory in the primary elections as sure and safe. The consequence is a greater intensity in the negotiations with the pro-government base and an “uncomfortable and silent” movement towards the “return of Lula”.

In the international camp the crisis in the Ukraine, although not yet resolved, for now does not show signs of having greater repercussions in the markets. In the USA, consumer spending increases, inflation is at a low level and disposable incomes shows signs of increasing. In the Euro Zone, activity keeps at an expansion level, based on the French economic recovery. Lastly, China’s industrial activity again losses momentum, a result of weak domestic demand, which leads to the possibility that the Government will take measures to stabilize growth rates.

With all these variables, what we in fact noted at the end of March was a financial market with a good performance…how? The Financial Market is an excellent thermometer, especially for the short-term, and prices in the situation (political, economic, international scenario, etc.)” well before it actually happens and fundamentally arbitrates inefficiencies and alterations in relative prices. Big boss!

Treasuries in the USA closed the month at 2.72%; S&P changed 0.69%; the NIKKEI closed at 0.09%; DAX at -1.40% and the FTSE at 6.11%. In Brazil, the Ibovespa closed the month at 7.05% and the IBrX at 6.89%. The highs for DIF15 were at 11.25% and DIF17 at 12.82%. The NTN-B 2050 closed the month at 6.7292% and the Dollar ended the month quoted at BRL 2.2630.

Economic Activity

The 1Q14 results continued to consolidate the forecast of low growth for the year.

The figures for both industry and retail in February show moderate growth. However, the first figures in March, for both sectors, point to a slowdown, which is in line with our forecasts for 1Q14. In more detail: in February ‘14 industrial production increased 0.4% and Jan ‘14 figures were corrected to 3.8%, a strong recovery in relation to the performance of Dec ‘13. In March ‘14, vehicle production dropped 22% MoM, with an increase in inventories. In the case of consumption, the prospect is for a drop in February ‘14, similar to Jan ‘14, wiping out the growth and, for March ’14, signs are of a negative performance.

In both the above cases, it is necessary to take into consideration the negative effects of Carnival, which reduces working days and may, in fact, have had an impact on numbers. However, it does not alter the generally projected paths and tendencies. In other words, it is possible that the ‘perfect storm’, so heralded by various analysts, will not materialize, but we are still stuck with a mediocre growth of around 1.5% for 2014.

Still on this line of thought, we cannot forget that, despite the necessary and positive increase in interest rates to control and stabilize prices (seeing as the Financial Policy does not help), without a doubt the Monetary Policy will have an effect on economic activity. Unfortunately, the deceleration of 2014 will contaminate the next few years. With the current economic policy we are converging towards a situation of low growth.

In any case, the problems we experience from the economic policy are so large, continuous and unreasonable that it can only be justified by an ideology imbedded subcutaneously, which blinds and drops everyone involved into a "vicious circle with continuous feedback."

We hope the reality of the facts will become the vaccine for this problem, with a (new) social outcry on the streets…or, at least, at the voting booth.

Fiscal Policy

The 1st of April is celebrated in various countries and, in English speaking countries, is known as April Fool's Day. We do not know when (possibly in the Nineteenth Century) or exactly from where (possibly France) or even why (some relation to the alteration to the Gregorian calendar by the Pope of the time), in any case, in Brazil the day is also known as Day of the Lie and is celebrated by pranks, jokes, deceits, deceptions and "white lies". Also, on the 1st, not only in April but every month, is the day we collect and compile data and information, re-check accounts and analyze scenarios and prospects.

Also, this last 1st of April we had some important announcements from the Minister of Finance in relation to the Monetary Policy, to which we must pay careful attention:

- WE WILL DELIVER A SURPLUS OF 1.9% OF THE GDP, WHICH WILL HELP COMBAT INFLATION;
- ACHIEVING THE FISCAL TARGET IS OUR COMMITMENT AND WE WILL WORK TOWARDS THIS MONTH BY MONTH;
- FISCAL MEASURES (TO INCREASE REVENUE) WILL ARRIVE IN DUE TIME.

Fiscal Policy has definitely been Brazil's Achilles heel in the last few years. It hinders Economic Policy from achieving its general objectives and causes faulty interpretations on the correct conduct of the economy for policy makers, investors, risk agencies and others, both within and outside the country. Not least, but fundamental for this variable, S&P downgraded the risk classification of Brazil – an enormous back step in all ways for the country. The words of the Minister are, however, very important for us to try to reverse the current situation, and he will have to honor the promises and maintain the small amount of credibility which he (we) have, domestically and internationally.

This cannot be an April Fool's joke.

International Environment

In her first speech as Chairman of the FED, Janet Jellen was not much lauded by the market: despite all bets being that she represented continuity to her predecessor Ben Bernanke. However, what was observed was a less dovish stance, with affirmation of continuity in ending incentives and also the start of an increase in interest rates, six month after the end of the monthly purchases of bonds: it did not last long… in truth, 12 days. The incumbent announced that the US economy and the country's job market are far from healthy and still need much support from Monetary Policies. These more dovish comments from the Chairman of the FED, place questions on the pace at which the institution will withdraw from purchasing Bonds and the postponement of the already seen increase in interest rates. The reaction: an immediate correction of Treasury yields (especially short-term) and of the American Stock Exchange. It seems to have been a small change in direction, minimizing further speculation, nothing to change the path outlined by Bernanke. The truth is that, fortunately, the improving economy has begun to bring the jobless back to the market. The economy is doing well (and will do better) without "help" from the FED; another place where less government is better government.

In Europe, new data on weak inflation in the Euro Zone reinforces expectations that the European Central Bank (ECB will put in place incentives to reduce the risk of deflation, until now under study. The script of the film is always the same: someone to "save" – a lender of last resort. However, in Europe, things are a bit more complicated, this because we are dealing with different nationalities and cultures, with secular animosities.

In China, we have possible signs of stabilization of industrial production. However, the PMI Services retreated slightly to 54.5. Consequently, the Chinese Government is likely to take small measures to stimulate the economy, offering tax incentives to small companies. In all, we presume China will probably continue growing: but at a more sustainable rate. Also in Asia, Japan should continue its policy of monetary incentives.

In short, the world's economies still do not offer reason for celebration, be it in the political, social or economic field. However, for the latter, it seems that the US (being the world's engine) could initiate a warming that, given the correlation between countries, could promote, even if indirectly, the start of greater economic activity.

Interest Rates

In the absence of a better instrument, a large part of the market has given even more attention to the minutes of the BACEN, published after COPOM meetings. This is important, but the attention is somewhat over the top: attempting to discover in the entrails and semantics the real intentions of the institution. With our model on BACEN's Reaction Function, together with our econometric projection model for the main macroeconomic variables, we attempt to identify what the organization will do, not what it should do, based on various analyses, regressions, exogenous variables: all in all a comprehensive insight, but focused. Using this model, for us, the cycle of monetary tightening policy has ended, at least until the elections. 2015 is another story, a new cycle.

In any case, inflation continues to cause worry...very much indeed.

March indicators show that the inflation target has become increasingly more distant. The Central Bank itself, in its quarterly inflation report, increased its 2014 forecast for the IPCA, in the base scenario, to 6.10%, from 5.60% in the December report. In conjunction with pressure from inflation, the market incorporated another 0.25% increase in the interest rate curve during the month. The big doubt is on the next moves, will the increases end at the April meeting, or is there room for further increases...opens up opportunities for arbitration. In our opinion, only an extraordinary event could change what we believe the BACEN will do and, in any case, we continue to reiterate that the actions of the Monetary Authorities are not sufficient to bring inflation to the target; the Government needs to control its expenditures, which are growing at a faster rate than revenue.

Foreign Exchange

The exchange rate, as another tool in the fight against inflation, has eased off this year, particularly over the last few weeks. The active involvement of the BACEN had an effect on currency quotes and the Government is now signaling that it is comfortable with a level of BRL 2.25, and not BRL 2.40. Who understands...?

The currency flow was positive in March, a result of foreign investments in local fixed rate investments, attracted by the high rates of return on Government Bonds, and large foreign funding through loans and the issue of bonds. The devaluation of the USD by 3.40% in March did not stop the swap bids of the BACEN. We maintain our forecast from the start of the year: quotes of between BRL 2.30 and BRL 2.40.

Stock Market

Ooops! Did the Brazilian stock market wake up? Do investors no longer consider it the ugly duckling? Nothing like that: as commented at the beginning of this report, the market reacts (and strongly!), anticipating facts, often in an exaggerated way that is corrected in the long-term.

It is a fact that Brazilian statistics have not changed in the last few weeks (on the economic side). However, it is also indisputable that the political side promises changes. Therefore, the financial market, which is not very sympathetic towards the economic team, sees changes in the Ministry of Finance and/or even a change of President (although less probable). The result: an agitated market.

At last, the Stock Market breached the 50.000 points. After months of closing negative, the IBOVESPA accumulated an increase of 7.05% in March and the IBrX was up 6.89%. Year to date, the Ibovespa is still down 2.12%. The index dropped to 45.000 points in the month due to the tensions in the Crimea, the cooling of the Chinese economy and the increased cost of energy production in Brazil, amongst other variables. The downgrading of the Brazilian rating by S&P was not a great surprise, considering the monetary policy, paltry growth and weakening of external accounts. We already expected this, as did the Stock Market – a fact reiterated various times on this space. Therefore, the announcement was already priced in and stocks continued their upward movement, as was needed to correct some of the previous “exaggerated” reactions. In addition, the Market also reacted to the positive news on change to the economic policy with the publication of the research indicating that positive feeling towards the government of Dilma Rousseff dropped to 36% in March, against 43% in November 2013, causing the market to gain momentum. The reduced tension in the Crimea also contributed to foreign investor appetite, with the Market a little bit more on the buy side. Despite the structural problems in Brazil, amongst emerging economies our country continues to be a good bet when redirecting flow to BRIC countries.

As we mentioned in this report last month, the drop of the Ibovespa since October last year seems to have been a technical correction: with a caveat for some companies/sectors facing a strong drop due to Government mismanagement and their weight in the Ibovespa.

However, there has been no fundamental change.

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