Planner Redwood Asset Management

MONTHLY COMMENTARY

APRIL 2014

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Introduction

It seems that the 'bread and circus' of the Roman Empire (food and entertainment) may not happen this election year. We are less than two months from a great event (World Cup), which has an enormous potential to deflect attention from everyone and everything, but focus has remained on the effective start of the Presidential elections. Yes, with a real possibility of a second round to the elections, April was marked by the intensification of political activity and a clear polarization of the great debate: more or less intervention of the Government in the economy. The electorate seems very attentive and 'satisfied'...hopefully.

In any case, no matter who is elected President of the Republic, adjustments to economic policies are a must. In truth, the current government has already 'signaled' this possibility, with the exit of Minister Mantega at the end of this year and the entrance, in his place, of the current President of the Central Bank, Alexandre Tombini. Should the President be re-elected, this could be a way out, but freedom must be given for measures to be taken, and they will be unpopular measures; such as increasing the cost of energy and gas, increasing interest rates and a strong tightening of monetary policy. It is obvious the financial market has not priced in this necessary change, should the current government continue in office. However, there is no doubt this will happen should one of the two main opposition candidates win.

In the US, the FED (Central Bank of the US) announced it would reduce the monthly Bonus it purchases by USD 10b, to USD 45b (as expected), despite the latest growth figures for the United States (practically stagnant at an annualized rate of 0.1%), caused by the strong deceleration provoked by the harsh winter in 1Q14. This is because expectations are for the economy to improve as a whole, with highlight on the creation of jobs. In China, despite having practically discarded the hypothesis of a hard landing, data seem to confirm a slow and gradual reduction in activity, despite Government incentives to reverse this scenario. The official Chinese PMI increased slightly from 50.3 in March to 50.4 in April. In the Euro Zone, the Industrial PMI increased from 53.3 to 53.4 and unemployment remained unaltered (11.8%). In summary, expectations are for a reasonable improvement for mature economies and a 'settling' for China.

With the local and foreign forecasts in place, we have become attentive to the movements of the markets, to the flow of events and the execution of our structural strategies, without having to stop enjoying the circus.

The Treasuries of the USA closed the month at 2.65%; S&P changed 0.62%; NIKKEI closed at 3.66%; DAX at 0.5% and the FTSE at 0.42%. In Brazil, the Ibovespa ended the month at 2.4% and the IBrX at 2.71%. The high for the DIF15 was 11.14% and for the DIF17 12.51. NTN-B 2050 ended the month at 6.52% and the Dollar quoted at BRL 2.219.

Economic Activity

Credibility is, for most people and Governments, one of the most valuable assets they can have. It is so important that, in its absence, the effectiveness of economic policies reduces drastically.

On April 29 this year, Minister Mantega made the following declarations:

- Inflation has a "detrimental effect" on economic activity and the consumer feels it the most, as he loses his purchasing power;
- Inflation damages all economic activity. Therefore, the government is totally committed to having Brazil reach the inflation target.

Also, in a recent interview he declared:

- We have the obligation to have the best possible performance of the economy; maintain inflation under control; deliver the promised surplus of 1.9% and not damage growth.

What market figures show:

- Forecasted inflation for 2014 above target (6.51%). Our forecast increased to 6.7% for 2014;
- Surplus of around 1.5%;
- Growth in economic activity for 2014 now at 1.63% (our original forecast for 2014).

According to studies conducted by the World Bank, in 2011 the Brazilian economy accounted for a little over 3% of the planets economy (6th or 7th position, depending on the method used). Another important indicator is that, in 2005, our economy represented 12.8% of the US GDP and, in 2011, this went to 18.1%! However, even more important, of our peers in the emerging economies, India went from 18.9% to 37.1% in the same period. The Chinese also are getting closer to the North Americans, with the economy of the Asian giant equivalent to 86.9% of the GDP of the USA in 2011, from 43.1% six years ago.

And where is credibility in all this? Well, with credibility we have the confidence of investors. With investments we structure our industries and other areas, resulting in an increase in productivity. In this way we grow!!!

Fiscal Policy

Things can always get worse, unfortunately. The risk at present is that the Fiscal Policy, main indicator and trigger for eventual changes to classification by Risk agencies, will be so badly conducted we lose our investment grade. An exaggeration? Not so much.

Despite promises from the economic team to increase fiscal efforts in 2014, the Government's accounts (National Treasury, INSS and Central Bank), reported in the first quarter a decline of 34.6% in relation to the same period of last year. The primary surplus ended 1Q14 at BRL 13.048b, equivalent to 1.08% of GDP. It was the worst first quarter result since 2010, when the surplus of the period was BRL 8.134b. In 1Q13, the surplus of the Central Government was BRL 19.960b (1.79% of GDP). While the revenue of the Central Bank increased 11.8% in the period, expenses increased faster: 15.1%. According to data from the Minister of Finance, the accounts of the Central Government in March had a surplus of BRL 3.173b, but this was not sufficient to recover from the bad result of February, when it reported a deficit of BRL 3.079b. In March last year, the surplus was only BRL 291.4m.

In March, the Treasury contributed with a surplus of BRL 7.737b and Social Security with a deficit of BRL 4.529b. The Central Bank reported a deficit of BRL 34.1m.

But this is not all! The promises of the President (without going into the merit of each one) to increase the benefits of the Programs (Bolsa Familia), readjust the Income Tax table and the appreciation of the Minimum wages, resulted in a pressure on public accounts. A little over half (51%) of the primary surplus of the Government in 1Q14 was obtained from non-recurring dividends and concession revenue. The accounted dividends (BRL 5.89b) were 667.5% more than those reported between January and March 2013 (BRL 767.4m). The maneuver to make the fiscal result less ugly is evident.

The primary accumulated surplus in the three months corresponds to 44% of the target fixed for the four month period ended in April. In other words, the target will only be reached if the result for April is more than 50% of the total value scheduled for the four months.

Despite this, the Finance Minister, Guido Mantega, insists in reaffirming the promise of a primary surplus for this year equivalent to 1.9% of GDP – figures for all the public sector. Again, credibility?

International Environment

Until very recently, a trigger to boost the continuation, or not, of the incentive program (QE) of the USA (today with lessened importance), the North American unemployment rate plummeted in April to reach its lowest level since September 2008. Unemployment in the US, calculated based on different research than that used to assess vacancies created by the economy, dropped 6.3% in April, from 6.7% in March. Although the result was better than economists estimated, the data was obscured by a strong increase in the number of people leaving the work base (806,000). The basis for the figures above is the Payroll data that, while demonstrating an economic acceleration, also reveal weaknesses (stagnated salaries, which could imply less consumption, and people abandoning the work market, but not considered unemployed). However, figures above expectation on job creation and unemployment will heat discussion in Wall Street as to when interest rates in the country will rise. For us, the figures are strong and will have the FED (American Central Bank) reduce monthly purchases of assets and interest rates may rise even by the end of 2014. This scenario would have a strongly repercussion on our economy.

In Europe, data show a better than expected situation for industry and unemployment in the Euro Zone. Calculated to measure the movement of orders and deliveries between companies, the PMI (Purchasing Manager Index) of the Euro Zone was at 53.4 in April, above the 53.0 of March, meaning an expansion of manufacturing activity, seeing anything over 50 shows an increase in invoicing. This recovery is visible in various countries: the PMI of Ireland is at its highest level in 38 months and, in Italy, it is at its highest level in 36 months. In fact, according to the research, all countries analyzed by the study registered a growth in production and new orders in April. This situation could have the European Central Bank postponing eventual measures to minimize the risk of deflation in the region. We shall see.

In China, the Industrial PMI (Official) in April was slightly above that registered in March (50.3), coming in at 50.4. A curious side fact: since assuming his position in the Government in 2013, the Prime Minister Li Kegiang has attempted to change mentality and not use short-term measures to boost the economy; he reiterates that reforms are the most promising option for the Chinese economy! Ching-ling, here is a lollipop! Congratulations!!!

Lastly, we note that the situation in the Ukraine continues...without great global effect. However, it is undeniable that geopolitics has played an increasingly important role in financial markets. In summary: something that now appears limited needs to remain so. The Investor is a skittish critter.

Interest Rates

The Central Bank, aware of its “non-autonomous” position and obedient to “general forces” seems to flirt with market projections for future inflation, setting aside technicalities for the political moment; this in the best hypothesis.

While inflation indicators remain high (for both 2014 and 2015), the curve of Future interest rates (the ETTJ – Interest Rates Term Structure) reduced the yield on all vertices at the close of the month. A paradox? No. The market remains divided as to the next move of the Central Bank: some believe there will be another increase of 0.25% at the May meeting, others, including ourselves, believe the cycle of increase is closed – not because of what it should do, but because of political conjecture and pragmatism, what it will do. In the communication issued at the last meeting, COPOM (Committee for Monetary Policies) informed that it would monitor the evolution of the macroeconomic scenario until the next meeting, leaving its next move open. On the short-term interest rate curve, as well as speculation on the SELIC rate, doubts about the World Cup holidays weighted heavily, despite there being no decision from BACEN whether the holiday will also be for the financial market. The devaluation of the Dollar and reduction of Treasury interest rates reflected in a deterioration in yield of the long part of the ETTJ. Different to the interest rate curve, the curve of inflation bonds had an increase in real interest on the short vertices (up to 2015), indicating a reduction in implicit inflation. For the long term, although less intense, a similar movement was noticed for short term implicit inflation. There we have another possible short-term distortion.

Foreign Exchange

Another month of positive flow for the exchange market, resulting in a 1.90% devaluation of the Dollar. This was a determining factor for the BACEN to partially rescue the currency exchange swap, rolling only 75% of maturities, which means the removal of approximately US$ 2.23b from the system. If on one hand we have ineptitude in conducting monetary policy, on the other we have inertia in the movement of inputting Dollars, recently initiated, which helps control prices and alleviate inflationary pressure on some segments. For ‘reasonably’ open economies, the FX could be considered the general level of prices…we hope it continues this way. We maintain our forecast for the YE14 Dollar rate at between BRL 2.30 and BRL 2.40.

Stock Market

It is the certainty of the “see-saw”: Bovespa Index up, index on Intention to Vote for the Dilma government down…

The financial market does not hide its preference for the Presidential elections. The stock market goes up on every publication of research, indicating a worsening of the positive evaluation of the Dilma government and a reduction in the Intent to Vote for the Government candidate. The movement was more intense for the shares of companies that suffer government interference, for example: Petrobras, which despite purchasing the refinery in Pasadena and other assets not sufficiently explained, had its share appreciate 11.73% in the month. We expect the movement to continue...Wise financial market, because it foresees changes in the conduct of the company (and all similarly affected companies will have the same behavior) and immediately factors this in...Simple, yes? Prudence, chicken broth and risk analysis (particularly with conditional probabilities) are never overrated.

Apart from government held companies, another sector that performed well in the month was Banking, which increased its share in Ibovespa’s new theoretic portfolio, with the stocks of Itaú and Bradesco taking the lead in participation. The increase in the weight of this sector is a result of the change in method of calculating the index, which now gives greater importance to the market value of the companies, rather than liquidity, a significant and important move. On the other hand, the electric sector had a boost from the announcement made by the CEEE that it will make greater use of market resources to reduce the problems seen in the sector.

The Ibovespa had another month of appreciation, closing up 2.40%, while the IBrX was up 2.71%. Apart from the research on Intent to Vote, the other factors contributing to the index working practically all month above 51.000 points were: (i) positive flow of foreign currency (*) and (ii) the good 1Q14 results reported by companies with an important participation in the index.

(*) The positive flow of foreign currency can be explained by the drop in yield of 10-year Treasury bonds and their differential against 2-year bonds: very low. This “phenomenon”, called flattening, of the American yield curve explains the increase in liquidity of the Brazilian market and other emerging economies...unfortunately this is not to our exclusive merit and neither can one say that it is a case of long-term investments...it is the certainty of the “see-saw”.

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