Planner Redwood Asset Management

MONTHLY COMMENTARY

JANUARY 2017

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Epigraph of the month... a propos of Brazil’s current predicament.

“We welcome change and openness; for we believe that freedom and security go together, that the advance of human liberty can only strengthen the cause of world peace.”

Ronald Reagan – former US President

Introduction

Finally 2017 has begun, bringing with it the greatest of all expectations, namely: the inauguration of Donald Trump's Presidency!

Following a presidential race with a clear media bias toward Hillary Clinton – Time magazine stamped Donald Trump's melting face on the cover, New Yorker called him "loser" and Newsweek "elected" Hillary Madam President – all networks now run around lost as President Donald Trump holds up to his campaign promises. It does not appear to be a "win-win" situation, especially under the strains, on one side, of swaths of unbecoming voters rejecting the elections' results, while, on the other, the settling administration's haste in implementing promised measures. Democracy's silver lining seems to have been touched upon even in venues such as UC Berkeley, a breeding ground for the "Free Speech Movement", where protests and unrest have taken place.

Trump's election ought to be, definitely, construed as a clear message that the American people wants change – and significant ones at that – that are both deep-reaching and wide-ranging, as well as with global impacts. It is only based on this understanding that the world will extensively negotiate the transition to this new state of affairs claimed by US voters which will affect all. On the other hand, taking for instance one of the game-changing policies, the new immigration rules seem over-reactive and precipitous… again, conversations may ease the way into holding up to campaign promises… a fierce polarization – notably of a global scale – may well entail extremely undesirable consequences. Former republican president Ronald Reagan's quote in the epigraph depicts the situation with precision: *"We welcome change and openness; for we believe that freedom and security go together, that the advance of human liberty can only strengthen the cause of world peace."*

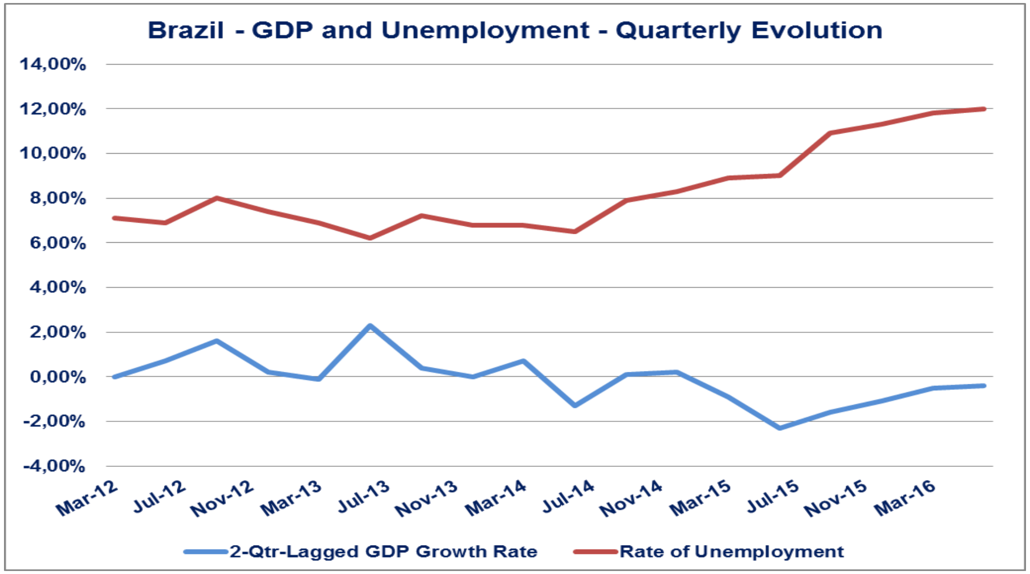
Whilst changing the *status quo* in the US and, by consequence, in the world (particularly in some US-dependent economies) will be a quite challenging task, for Brazil we reassert the positive effects this change of the guard in the US might impinge on the country. Indeed, Trump's administration may represent a positive externality, for reasons directly or indirectly reliant upon our global-positioning strategy. An adjustment addressing our domestic problems – the solutions for which seem to be in line – will embolden this effect. On the other hand, the asymmetry among various countries' adjustment to this new reality and their own challenges – be it the European Union's endless inner problems, be it the Chinese economic slowdown – imposes maximum rigor in following up and observing in order to be properly positioned.

In this landscape, US Treasuries closed the month at 2.48%. S&P varied 1.79%, NIKKEI at -0.38, while DAX at 0.47% and FTSE at -3.35%. Ibovespa ended the month at 7.38% and the IBrX at 7.21%. Highs for DIF18 at 11.50% and DIF21 at 11.34%. NTN-B 2050 closed the month at 5.5809% and the USD (PTAX) at BRL 3.1270.

Economic Activity

In line with the rapidly spreading relative optimism among us in recent times - particularly with the ongoing fiscal consolidation and, not least, social security, labor and tax reforms, etc. – the political realignment required to attain this measures seems to be straighten up. This is a *sine qua non* condition to economic recovery which, as we mentioned here time and again, will be somewhat gradual.

However, if the upswing is already "anticipated" in the face of upcoming reforms and adjustments, the reflexes of such prognostics (on people's lives) are still a challenge to economic policy management, for the effect on employment, for instance, is disperse and unevenly spaced in time (close to six months, best case scenario) with signs of economic recovery. Moreover, this latter needs to be consistent within the lag period in order to bring it to operation. This may impose fragility in the conduction of proceedings, for the obvious reasons of popular unrest and all that stems from it, and thus demands attention and solid attitudes leading to an eventual change of course.



Source: IBGE | Elaboration: Planner Redwood

Unemployment reached startling 12,3 million workers at the end of 2016 with the negative economic growth forecast of -3.5%. It is a record-breaking figure within the time series of the Continuous National Sampling Survey of Households (Pnad) – an addition of 3.2 million unemployed over 2015. The average rate of unemployment in 2016 was 11.5%, against 8.5% in 2015 – a 35,3% increase. Our studies show that the average rate in 2017 will be on the rise (12.66%), with a forecasted retreat only in 2018 (11.66%), when the economy will most likely be in a sustained growth path.

The chart above depicts the behavior of these variables in time and intensity – which, for better understanding, we present the data with a two-quarter lag – and assumes that studies and measures be pursued at this moment to alleviate this situation.

The Federal Government seems to be on top of this, but it is always good to remind the "challenges" in trying to solve macro problems with micro solutions.

Fiscal Policy

From the start of the time series, back in 2001 by the BACEN, it is the first time the Overall Public Sector presents a primary deficit as large as the one recorded in 2016: BRL 155.8 billion or 2.47% of GDP!

The evolution of such results is also tantalizing: in 2014 the accumulated deficit was BRL 32.5 billion (0.56% of GDP) and in 2015 it was BRL 111.3 billion (or 1.85% of GDP) – keeping in mind that the Public Sector covers the Central Government (Social Security, Central Bank and the National Treasury), States, Municipalities and State-owned companies – excluding Petrobras and Eletrobras.

Figures such as those presented above irrefutably illustrate our predicament, and where we were headed should we not have changed courses… the conduct in recent past was more than a flirt with management irresponsibility with public accounts and has thrown us perilously into a quagmire with consequences of cataclysmal proportion as regards the future of the country. Besides the ongoing adjustments and the enhancement of the Fiscal Accountability Act, among others, Brazil requires a real foothold (forget the existing structure of oversight, for it did not work!... even considering the limitations and constraints they are subject to today) to support situations of this nature – should they take place or not. We need a "Consequence Policy" that is strong and pragmatic, and also Governance and systematic, independent and continuous oversight so as to keep the National Congress and society at large duly informed about events and their developments.

However, if the situation is so adverse and yet a deficit is projected for 2017 around BRL 143 billion (with doubts over the likelihood of such "success"), how can we be reasonably optimistic and the market itself pricing down, systematically, our risk levels? It is fairly simple: expectations have severely improved! The trend we were on has a great chance of being reversed, and that implies a complete change of our present and future scenarios. *Coeteris Paribus* (all else constant) "solving" this enormous domestic puzzle by itself alleviates of situation to a great extent, and thus repositions us internally and in the eyes of the world – especially to foreign investors.

Therefore, achieving the 2017 target is not trivial, but we have room to do it. Doing this, nonetheless, will require an unbending commitment with available resources (see the situation in States), expenses cutbacks, search and formulation of alternatives to extraordinary revenues (such as a replay of fund repatriation) and asset liquidations, among others.

Parallel to all this, the unlikely but possible activity jumpstart (at least in the margin for some sectors) may well ameliorate tax collection… despite the fact that this assumption should not be seen as a "credible source", but as a "bonus" at the end, should it come.

At last, notwithstanding our constant living on the edge of policy and economics, it is undeniable that the course of Economic Policy has changed and the results are coming in, albeit timidly. Continuity in proposed reforms, the rigorous control of expenses and its enhanced efficiency, the alternatives to additional revenues improve the overall process – with positive feedbacks -, for these actions will reinforce the speed of economic recovery and this latter, in its turn, will boost tax collection. A virtuous cycle is about to be start.

International Environment

The term uncertainty has been reflexively repeated in the last weeks, especially in the aftermath of Donald Trump's victory. In fact, the world economic outlook has become excessively troubled by industrial countries' economic policies and underscored by the reflexes of a new era dawning upon the US. Various terms with the same meaning have been often heard, such as protectionism, populism, isolationism etc; all of which, without exception, stems from dissatisfaction promoted by the economic and welfare misalignment to which some economies were subject to – an adjustment toward the asymmetry of countries that performed better in the globalized world.

These movements of dissatisfaction have gained momentum for some time now, and in societies that no longer envisage any chance of economic improvement and, further, still see unbearable asymmetries regarding other countries. This instability of an economic nature among countries may trigger serious consequences, notably because political parties and other movements contest the current *status quo* and will gain further terrain… examples of such are abundant.

The issue in front of us is that this phenomenon may be no longer temporary or of easy reversion. It may also be that BREXIT, Trump, Le Pen, the eventual crumbling of the European Union and other movements alike transcend mere "conjunctural" events and that by next election, everything will not be back to "normal". We may be facing a lasting arrangement, of game-changing proportions and precepts. Should this new situation consolidate as a new pillar, we must prepare for profound changes in the relations among nations.

Multilateralism as we know it, founded and couched on the Postwar institutions, along with the apparatus developed in the last decades to promote lower instability and broader opportunities on more equal terms for free trade may well have their days numbered. Or could it be this system's very "failure" the cause of our current turning point?

At any rate, what matters is that the view from our standpoint does not envisage a smooth path ahead. Rising tensions with no common ground for fruitful dialogue will only make matters worse. As lasting as this phenomenon may be, the truth of fact is that a rupture, even a conjunctural one, of relations among countries (sponsored by the US and others in Europe) is already a reality.

In this sense, assessing the international outlook is of utmost importance, for a diligent and adequate repositioning in advance of events will enable a free "transit" in this "new normal" with lesser impacts, until a new Bretton Woods agreement is brought to the fore. Or not.

Spite and whining against these "populist, protectionist and isolationist movements" seem to fall on deaf ears – however legit. Some actions by developed and so-called "liberal" countries (in the Anglo-Saxon meaning of the term) went too far to be deterred by these groups. Brace yourselves!

Interest Rates

The Copom has surprised all financial analysts!

The members of the Monetary Policy Board have decided unanimously to cut down interest rate SELIC, by 75 b.p. The vast majority of the financial market participants, including ourselves at Redwood forecast at 0,50% b.p. cut. The magnitude of the cut was due to allegedly anchored inflationary expectations and a dragging economic activity – our models did not point to such anchorage settlement, and therefore suggested parsimony in cutting rates, although aggregate demand forecasts indicated further contraction. With this cut, many economists have revised their SELIC forecasts down for 2017 to single digits: 9.5%, according to the Focus Survey as of 27 January 2017. By the Taylor Rule (a cornerstone to ALL central banks), further cuts of SELIC are to be expected for 2017. Just like the market, we have revised of expectations toward interest rates, SELIC (which heeds the Taylor Rule), albeit still at double digits, namely: 10%.

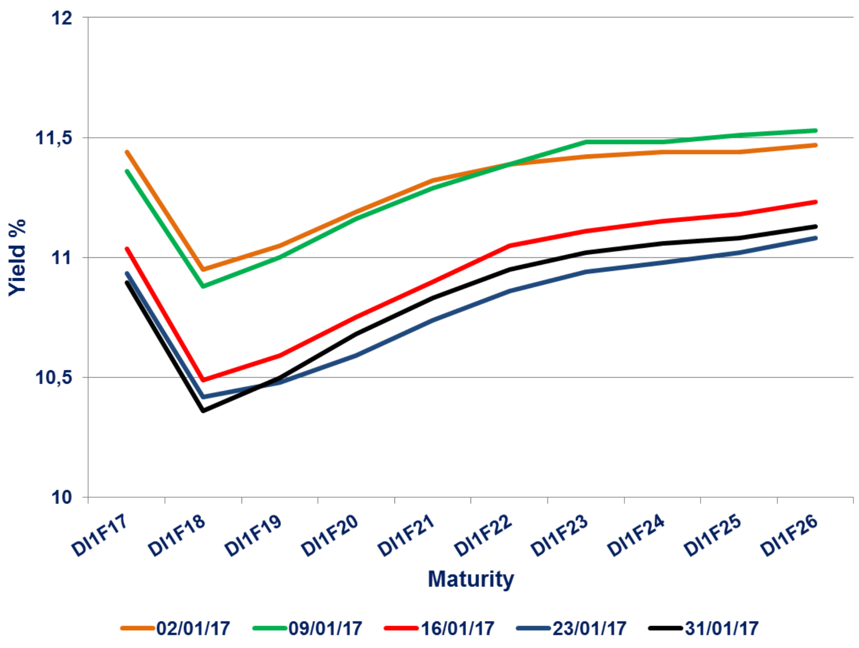
The Committee's decision followed the release of the Headline Consumer Price Index (IPCA) for December at 0.3%, with a 6.29% accumulated within the year, thus below target ceiling of 6.5%. As for 2017 and 2018, the range of tolerance around the 4.5% target has been narrowed to 1.5% both ways. Just as in the case of SELIC, economists in the financial markets have reduced projections for inflation for this year to 4.70%. This number indicates that inflation is converging toward the center of the target range. As for the Central Bank, projections for inflation in this scenario of reference is 4.0% for 2017 and 3.4% for 2018 (in line with Redwood's scenario). Declarations by the chairman, Ilan Goldfajn, that Brazil should approach the inflation target in the long run around 3%, at similar levels to emerging economies, indicate the priority given to inflation control by the institution. Still, a warning sign is given as regards the room for SELIC cuts.

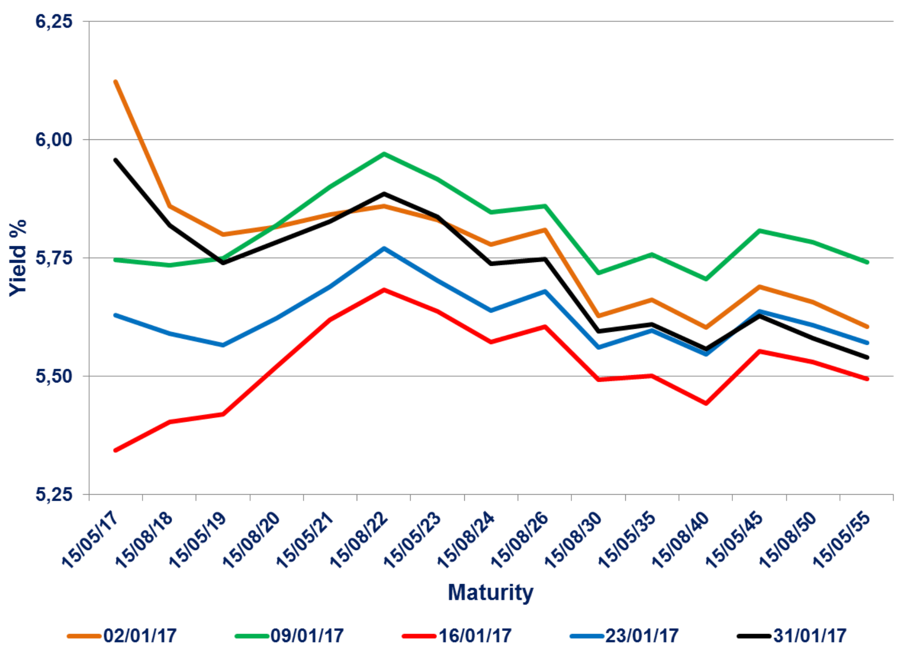
Figures indicate that monetary policy is on the right track, but getting this policy right is not enough to drag the country out of recession – reforms to be implemented, previously mentioned, are fundamental and will pave the way for future successful economic policy. In this line of argument, a controversy was stirred regarding the proper relation between interest rates and inflation, or yet, that in the short run high interest reduce inflation but not in the long run – e.g., there would exist a positive relation between inflation and interest rates… the so-called neofisherian hypothesis. Even the Fiscal Theory of the Price Level is invoked, which states that it is up to fiscal policy to anchor expectations and determine the rate of inflation. Up until recently, worries were that we were on the brink of fiscal dominance, now this! BACEN: let these studies and ideas mature with the models at the academic frontier… do focus on the dominant hypothesis in macroeconomics. At the risk (time and again) of being redundant: inflation is essentially a monetary phenomenon – period.

In the next chart, we can clearly observe how markets have anticipated the decision by the Copom to cut down the SELIC by 75 b.p. Long run future interest rate contracts, which were negotiated around 11.50% yearly (curve as of 9th January), moved down to 11.25% (curve as of 16th January) right after the meeting. Similar movements overtook NTN-B coupons.

Interest Rates

Yield and Coupons Curves (NTN-Bs)





Foreign Exchange

The Dollar accumulated losses of 4.05% in January, closing at BRL 3.1270.

The beginning of the year was marked by a strong downward pressure on the dollar on account of corporate capital foreign inflow. Only in January, securities issued by Brazilian companies added up to USD 6 billion, against USD 19 billion in 2016 overall. For instance, Embraer itself issued USD 750 million. And further issuance must continue in the next months.

In January, the Central Bank acted on the currency markets with a supply of tradition exchange rate swaps to roll over contracts maturing in February. These operations have an impact on the futures markets similar to sale of dollars and the monetary authority has promoted daily auctions in the last days of the month so as to lengthen these assets' maturities. According to the institutions' chairman, the stock of currency swaps was reduced, as of now, from USD 108 billion to USD 26 billion and can be reduced further in March, when other USD 7 billion worth of contracts mature – in our opinion a lower stock of swaps is great news, and exceptional if it becomes zero! He has also underlined that the world economy is slowing down, which favors a hike in commodities prices. As for the domestic front, the perception that the economy is being well managed favors investments in BRL, but political uncertainty may generate relevant noise and boost risk premiums.

Beyond capital inflow to the country and the "liquidity maintenance" by the Central Bank – just to keep us diplomatic in words and assessments – the tranquility of the political scenario, due to the legislative recess in Brasilia (DC), has contributed to plunge of the dollar. Exchange rate policy conducted by Bacen's *experts*, as well as the assessed variables SELIC and inflation – which affect the Net Debt of the Public Sector ratio to GDP (NDPS/GDP) – must be carefully conditioned by the sensitivity of the Debt-to-GDP ratio to changes in the exchange rate and its behavior through time, given that this relation is inverse, immediate and of a non-negligible impact.

In the world at large, uncertainties about Trump's administration in the US (or could it be that agents are not willing to acknowledge what is coming?), particularly due to the "lack of clarity" about its intended economic policies, influenced negatively the dollar all across the board. The Dollar Index, for instance, has accumulated losses over 3% in the month, partly reverting the observed high in the aftermath of the republican victory last fall. But is this understanding adequate and correct for the medium and long runs? The market can trick us, especially in the short run…

A more detailed analysis and with "alternative facts" requires us to evaluate the scenario under Trump (previously covered in Redwood Macro scenario 4th qtr. 2016) and to adjust our positions, eventually: (i) fiscal expansion, (ii) employment growth, (iii) inflation hike, (iv) tight monetary policy, and (v) economic growth… and as consequences: (vi) strengthening of the dollar, (vii) higher interest rates and (viii) worsened financial conditions to those countries resisting adjustment to the new "environment".

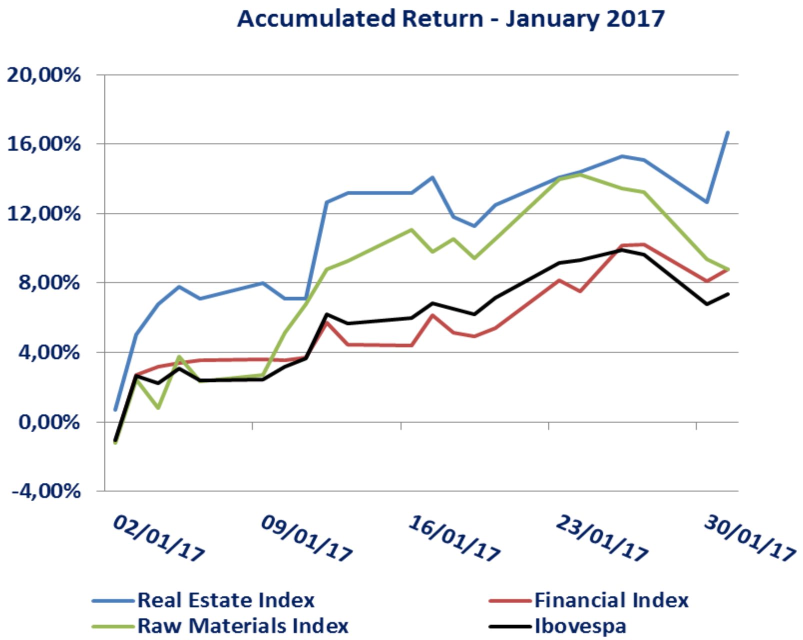
It is convenient for us to reevaluate deeply "our preferences" for our exchange rate and its policy, or even better, that this latter reaches its dynamic equilibrium level and also to concern ourselves with what is within reach and matters!

Stock Market

Our scenarios do not indicate growth for Brazil in 2017, but could it be that other sectors like the one represented by the Ibovespa are at variance with this statement?

Considering the Ibovespa alone, one could say yes. This index has gone up by 7.38%, having the prices of 12 stocks negotiated on the market increased by 50%. Companies favored by the interest rate cuts, such as construction companies and shopping malls had a strong upswing (see the Real Estate Index in the chart). The commodities-negotiating companies gained shelter under the Trump's “protectionist discourse” and the positive figures of the Chinese economy in 2016. There was a strong foreign investment inflow to Brazil in the month after two months of profit-realizing outflows.

Internally, consecutive cuts of the interest rate, the recovery of credit operations and the perspective of improving fundamentals for the Brazilian economy “make room” for further appreciation of the Brazilian stock market. With lower interest, companies will have greater stamina to renegotiate debts and may also raise funds with lower financial costs domestically. However, one cannot forget that investments will not take place in the short run, given the high idle capacity and leverage that characterizes a major part of companies. The unemployment rate is likely to worsen, stymieing consumption and the need to increase supply… that is, many things play against it.



Source: BMF&Bovespa | Elaboration: Planner Redwood

Furthermore, under the fundamentalist or value-based analysis, not many companies promise strong strengthening when risk-adjusted, and above all if compared (in a standard portfolio mix) to Fixed Income possibilities. Nonetheless, if the long run is taken into account, portfolio diversification and expertise in specific selection of companies and sectors, it could be a good “bet”.

In sum, in this year's beginning the Brazilian stock market seems not to be the “golden boy”… yet. We need not only to see this “confluence” of good omens take hold (interest rate cuts, implemented reforms, rise of confidence, etc.), but also a rearrangement of companies (deleveraging, operational rebalancing etc.) and in due time verify the increase of demand for loans to foment agencies and banks. There some “lead indicators” to this process that allow us to reassess the context, such as the gradual recovery of consultations with those supplying credit… in truth, this is the first stage to loan concessions, among others.

Prudence and a warm chicken broth do no one any harm.

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